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State and Local Governmental Developments— 2001

Complement to AICPA Audit and
Accounting Guide *Audits of State
and Local Governmental Units*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Notice to Readers

We, as members of the AICPA staff, have developed this Audit Risk Alert to provide you, as an auditor of financial statements of state and local governments, with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits you perform. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA. This document presents brief summaries of recently issued accounting and auditing pronouncements and legal and regulatory provisions. We present those summaries for your information only; you should not rely on them as a substitute for a complete reading of the source material.

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We wish to thank Venita M. Wood, an independent consultant in governmental accounting and auditing issues, for her substantial contribution in developing this Audit Risk Alert. We also wish to thank the various members of the governmental accounting and auditing profession and related disciplines who contributed to this document, including William V. Allen, Jr., David R. Bean, Joseph C. Blythe, Steve Bruza, Marcia B. Buchanan, F. James Charney, Marilyn C. Doolittle, Randal J. Finden, John Fisher, Eric V. Formberg, Wesley A. Galloway, Joseph Hebert, L. Michael Howard, Karl D. Johnson, Steve Kenneally, Deborah A. Koebele, Mary Jo Koschay, Dean Michael Mean, Richard A. Noll, Jill R. O'Brien, Andrew Parker, Kinney Poynter, Terrill W. Ramsey, John E. Reagan III, Roberta Reese, George A. Rippey, Kenneth R. Schermann, Gilbert Tran, David A. Vargas, James M. Williams, Jon A. Wise, and various staff members of the Internal Revenue Service.

State and Local Governmental Developments— 2001

Complement to AICPA Audit and
Accounting Guide *Audits of State
and Local Governmental Units*

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State and Local Governmental Developments—2001

Economic and Industry Developments

What are some of the significant economic and industry developments of the past year that are relevant to state and local governments?

The State of the Economy

Surveys of state and local governments in mid- to late 2000 indicated that economic conditions were strong but that revenue growth was slowly leveling off. Governments expected the same conditions to continue through 2001. However, the sharp downturn in national and certain regional economies that started late in 2000 has changed those expectations. The downturn has started to affect sales tax revenues, and personal income tax revenues also could be affected if employment softens.

State Governments

A National Conference of State Legislators (NCSL) survey indicated that, at the end of fiscal year 2000, states were in their best financial position since 1980, with the aggregate ending fund balances of general and “rainy day” funds at almost 9 percent of general fund annual expenditures. That condition was widespread—twenty-one states had fund balances exceeding 5 percent, and another twenty had fund balances exceeding 10 percent. At the time that survey was conducted, the states expected the aggregate balances of their general and rainy day funds to be just below 6 percent at the end of fiscal year 2001 because of slowing revenue growth. Because of the optimistic picture in 2000, many states continued to enact tax reductions, which were expected to reduce the states’ total fiscal year 2001 revenues by about \$5.8 billion. A few states enacted tax cuts in the form of one-time rebates or other

kinds of temporary reductions, thinking they might need to hedge against a possible economic slowdown.

Despite that study's rosy predictions, another, more sobering, NCSL survey of state fiscal conditions early in 2001 showed that the economic downturn was starting to affect the states. Thirty-three states reported that revenues were on target or above forecasted levels; whereas two months earlier, forty-four—an additional eleven states—had reported that condition. Thirty-one states reported at least a small amount of spending in excess of budgeted levels. Overspending in the Medicaid program continued to be a sizeable problem in many states. Although most states did not anticipate the need to cut their fiscal year 2001 budgets to keep them in balance or to consider tapping their reserve funds to “stay even,” almost twenty states thought budget cuts were likely or possible. In addition, about ten states thought the need to use reserve funds was likely or possible. The survey also showed that preliminary revenue forecasts for fiscal year 2002 reflect concerns about the strength of the economy and even slower revenue growth.

Local Governments

Local governments had the same strong but steadily slowing economic conditions as state governments during 2000. About three-quarters of the cities responding to a survey conducted by the National League of Cities described their financial condition in 2000 as better than in 1999. In the aggregate, property tax rates held relatively steady, but a large number of cities increased fees. While revenue growth slowed, expenditure growth continued. About 84 percent of the counties responding to a survey conducted by the National Association of Counties in 2000 reported then-current financial conditions ranging from “very good” to “excellent,” and almost 50 percent of them expected financial conditions to improve over the next three years. The strongest financial conditions were reported by urbanized counties. At that time, counties also were holding relatively steady on tax rates but were raising fees. About one-quarter of the counties responding to the survey indicated implementing new state-mandated programs in the last fiscal year, many involving public safety programs.

Public Employee Retirement Systems

Public employee retirement systems (PERS) that administer defined benefit pension plans also have been faring well, not only because of the bull market of the 1990s, but also because of policy decisions made starting in the late 1970s to improve PERS funding. Last year, the Census Bureau reported that the assets of the more than 2,000 state and local government PERS increased \$190 billion in 1999, reaching a record high of \$1.9 trillion. A couple of surveys of the 1998 and 1999 data of large PERS show significant strength in their funded ratios, which compare the actuarial value of plan liabilities to assets. The funded ratio of a significant number of those PERS was well over 90 percent, with many over 100 percent. Because many PERS are approaching or already have achieved a fully funded status, some plans have reduced employer contribution requirements or enhanced benefits, and others are considering following suit. A few plans are using excess PERS funds to match employee contributions to deferred compensation plans. (See the additional discussion in the later section of this Audit Risk Alert entitled “Governmental Employee Benefit Plans.”) However, recent downturns in the financial markets may cause PERS to slow or reverse these actions.

Possible Effects of Recent Developments

The rapidly slowing economy during the last part of 2000 and so far in 2001 may have caught some state and local governments inadequately prepared. Governments may have initiated new programs, issued debt for construction projects, or enacted revenue cuts based on financial models that presumed gradual slowing in revenue growth. In your audits of governmental financial statements, you should be alert to the possibility of reduced revenues and actions that the governments may have taken to “put on the brakes” and consider how those matters may affect their financial statements. You also may need to closely evaluate the governments’ estimates of uncollectible receivables. The economic slowdown may negatively affect revenue collection patterns and may make less reliable estimates of uncollectible receivables that are based on historical patterns.

Taxation of Internet Sales: The Debate Continues

For the past few years, we have alerted you to the continuing debate over the taxation of Internet sales. State and local governments are concerned about losing sales and use tax revenues because of untaxed Internet sales. A recent estimate of the amount of sales tax revenue that will be lost in 2001 because of the nontaxation of Internet sales puts the amount at \$2 billion.

When we left the saga of the taxation of Internet sales in last year's Audit Risk Alert, the Advisory Commission on Electronic Commerce (ACEC) had just submitted its report to Congress. That report recommended that, among other actions, Congress (1) extend the existing ban (which is slated to expire in October 2001) on new taxes on Internet access and on multiple or discriminatory taxes on electronic commerce (e-commerce) and (2) take steps to simplify state and local sales and use taxes. (Internet businesses claim that disparities in sales tax systems among the various jurisdictions are too burdensome to administer.) Despite the introduction of numerous bills, Congress was unable to pass Internet taxation legislation last year. However, the attempts continue—Internet-taxation legislation already has been introduced this year.

The states also are attempting to deal with the issue of sales tax simplification. The District of Columbia, forty-five states, and thousands of local governments impose sales taxes. To deal with complaints about system disparities among the jurisdictions, the National Governor's Association created the Streamlined Sales Tax Project (SSTP). The SSTP, comprising tax administrators from thirty states, developed model legislation to unify and simplify sales and use tax administration among the states that adopt the legislation. The SSTP hopes that, by unifying and simplifying sales tax systems, Internet businesses will voluntarily collect sales taxes. The model legislation, entitled the Uniform Sales and Use Tax Administration Act (the Act), would authorize a state taxing authority to enter into an interstate compact, the Streamlined Sales and Use Tax Agreement (the Agreement). The Act and related Agreement would, among other matters, establish more uniform state tax rates, establish uniform administrative standards, and develop and adopt uniform definitions of sales and use tax terms.

However, the Act ran into a snag when a task force of the NCSL took significant exception to some of its measures. The NCSL drafted and distributed its own version of model legislation to simplify sales taxes. State legislatures are now considering whether to adopt legislation and, if so, which version.

Help Desk—The Act is available on SSTP's Web site at www.streamlinedsalestax.org. The NCSL's version of the model legislation is available on the NCSL Web site at www.ncsl.org/programs/fiscal/tctelcom.htm. The NCSL site also includes a document that lists the amendments that the NCSL made to the SSTP Act.

Emerging E-Government Applications

State and local governments came slowly into the electronic age, but now they are blazing onto the Internet, especially with electronic government (e-government) applications. E-government is the process of using the Internet to provide information and services to citizens and otherwise conduct the business of government. At their simplest, e-government applications can be achieved simply by using a Web site as a bulletin board or database—"publishing" annual financial statements, posting school closing data, and permitting access to real estate and court records.

However, the interactive applications—those that process transactions—are building steam. (Some of these interactive applications have been facilitated by recent legislation. See the discussion later in this Audit Risk Alert in the section entitled "Electronic Contracts and Signatures.") One estimate indicates that, by 2003, more than 60 percent of state and local government will let citizens conduct some sort of remote transaction. It also has been estimated that, by 2006, federal, state, and local governments will collect 15 percent of their fees and taxes online and receive 333 million online submissions of various kinds.

Some of these interactive applications are fairly predictable and increasingly common in larger governments—for example, filing tax returns, paying taxes, and applying for vehicle registrations and driver's licenses. Other interactive applications are relatively unique or new—for example, holding auctions of delinquent tax

properties, taking bids on competitive sales of municipal securities and purchases of investments, registering deeds and mortgages, and voting. (See also the section later in this Audit Risk Alert entitled “Securities and Exchange Commission Activities.”) Even small governments have e-government possibilities—issuing local park permits and registering children for municipal sports programs, for example.

The information technology (IT) costs of e-government will be high. It has been estimated that, by 2005, state and local governments will spend \$12.5 billion on e-government. Larger governments can combine technology to serve multiple purposes—electronic business (e-business), such as online purchasing, as well as e-government. Smaller governments are finding strength in numbers as industry-based organizations develop alliances with technology companies to offer those governments an Internet presence.

You should stay abreast of the e-government initiatives that the governments you audit undertake. In performing analytical procedures, you may see increased IT costs. Further, the collection of certain information and payments over the Internet will introduce IT applications and may introduce the use of service organizations that need to be considered in your evaluation of the entity’s internal control over financial reporting. (See the section later in this Audit Risk Alert entitled “Service Organizations.” In addition, see the discussion of Statement on Auditing Standards (SAS) No. 94, *The Effect of Information Technology on the Auditor’s Consideration of Internal Control in a Financial Statement Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 319], which amends and expands the discussion in SAS No. 55 of the auditor’s consideration of an entity’s use of IT in controls relevant to the audit, in the section entitled “Recent Auditing Standards.”)

Collecting Revenues Through Credit Cards

State and local governments are increasingly allowing taxpayers and others to pay taxes and, sometimes, fees and fines with credit cards. Some governments have found that accepting credit cards improves the timeliness and collectibility of payments, even the collectibility

of long-delinquent amounts. Many governments accept credit card payments over the Internet, allowing taxpayers and others to make payments twenty-four hours a day. Internet-based payment processes require the payer to input data about the bills they are paying, which reduces the data entry effort by the government or its data processor.

One issue that can arise when a government begins a credit card collection program concerns card fees. Credit card companies charge vendors a fee for card use by paying vendors less than the amount vendors charged the consumers. Generally, governments are reluctant to accept, or may be prohibited by law from receiving, reduced payments of taxes, fees, and fines. A natural solution to this problem is for the government to surcharge the credit card owner for the fee. However, the standard contracts that vendors have with credit card companies do not permit such surcharges. The processing organizations that handle credit card payments for many governments and governments that process payments directly have overcome that issue by charging “convenience fees” rather than surcharges. Although largely a matter of semantics, the use of convenience fees is now generally accepted for credit card payments to governments. Usually, the amount of the convenience fees is equal to the governments’ costs of accepting the credit card payment, including the cost of any third-party processing company the government uses.

If a government you audit collects revenues through credit card payments, you should consider determining that it has adequately addressed any contractual prohibitions against surcharges. You also should consider the effect of the use of a credit card processing company and electronically transmitted data on the government’s internal control over financial reporting for those revenues. (See the section later in this Audit Risk Alert entitled “Service Organizations.”)

Fuel and Electricity Price Issues

Automotive fuel prices rose dramatically last year, and as soon as those prices began to abate in the late summer of 2000, natural gas, heating oil, and electricity prices began to rise. Hard hit by electricity price issues were the Western states, particularly California. The

structure of California's electric deregulation legislation combined with a lack of generation capacity, high usage, and record natural gas prices significantly increased electric prices for the state's three investor-owned utilities (IOUs). The state's municipal electric utilities—exempt from the deregulation legislation—were less affected by the market pressures because they continued to obtain most of their electricity from their own generating plants and from fixed-price contracts. During the winter of 2000-01, reduced hydroelectric output in the Northwest forced that area's municipal electric utilities to buy high-priced power on the spot market and to approve or propose rate increases for retail customers. The Bonneville Power Administration, a federal agency that supplies electricity in the Northwest, is expected to significantly increase its rates beginning in October 2001.

Other areas also have been affected by energy prices. When electricity prices more than tripled in one Southern city last winter, the city considered municipalizing the IOU and extended the payment date for annual property tax bills, and the IOU donated shareholder funds to local agencies to help citizens pay utility bills. Municipal utilities with excess power to sell on the open market have experienced increased revenues from the higher market prices, although they also faced increased credit risk from supply contracts with utilities in weakened financial positions because of those prices.

You should consider whether and how the past year's fuel and electricity prices affect the financial statements of the governments you audit. High prices may have increased the automotive fuel costs of entities with large fleets, such as transit districts, law enforcement agencies, and school districts that transport students. High prices may have increased an entity's natural gas, heating oil, or electricity costs, especially for entities that use a significant amount of electricity, such as water and sewer utilities, or those that experienced harsh winter weather. Governments that sell natural gas and electricity may have both increased costs and revenues, and may have an increased credit risk from customers and, thus, a higher allowance for uncollectible receivables. Other financial effects may result from fuel and electricity price issues in individual jurisdic-

tions, depending on actions taken to relieve the effects of high costs on the jurisdiction's citizens.

Rising Health Care Costs

According to survey results from various health care consulting firms, employers experienced health care cost increases in 2000 that were more than double the general inflation rate. This was the third year of such major cost increases. Even higher increases—on the average 10 percent or more—are expected in 2001. Many employers have absorbed much or all of the increases because of the need to retain employees in the tight labor market.

Consequently, when you perform analytical procedures to compare current-year employer health care costs to prior year costs, you may see large increases. When auditing a government that “self-insures” employee and retiree health care plans, you should consider the need to closely evaluate whether the estimated claims liability appropriately considers rising health care costs.

Claims Information Database

Do the governments you audit “self-insure” or use a public entity risk pool in lieu of buying insurance from a commercial insurance company? Do you audit a public entity risk pool? Since the 1980s, governments have moved away from buying commercial insurance in an attempt to contain costs, resulting in the insurance industry having reduced data on losses that are unique to governments. Government-specific loss data can help the governments you audit better estimate their risk exposure liabilities, such as those relating to activities involving student and public transportation, law enforcement, and emergency vehicles. Better liability estimates could reduce audit effort in evaluating those estimates

A 1995 antitrust settlement agreement between twenty states and the insurance industry required the creation of a database facility to provide aggregate and comparative data to meet public entity information needs. The result was the Public Risk Database Project (PRDP), which has introduced Data Exchange™, a Web-accessible

database designed to be the nation's primary source of public entity loss information and reports. Initially, the database is accumulating liability loss and exposure data, but it will expand in the future to cover workers' compensation and other coverage areas. Data Exchange is being populated with information submitted voluntarily by governmental entities with risk financing activities, public entity risk pools, third-party claims administrators, and insurance companies. Once there is sufficient claims information in the database—perhaps later this summer—Data Exchange will provide subscribers with reports.

Help Desk—Information about Data Exchange is available on the PRDP Web site at www.prdp.org.

Executive Summary—Economic and Industry Developments

- Surveys of state and local governments in mid- to late 2000 indicated that economic conditions were strong, but that revenue growth was slowly leveling off. Governments expected the same conditions to continue through 2001. However, the sharp downturn in national and certain regional economies that started late in 2000 has dampened those expectations.
- The debate continues over the taxation of Internet sales. State and local governments are concerned about losing sales and use tax revenues because of untaxed Internet sales. Congress is considering Internet taxation legislation, and states are attempting to deal with the issue of sales tax simplification.
- State and local governments came slowly into the electronic age, but now they are blazing onto the Internet, especially with e-government applications to provide information and services to citizens and otherwise conduct the business of government.
- State and local governments are increasingly allowing taxpayers and others to pay taxes and, sometimes, fees and fines with credit cards. If a government you audit collects revenues through credit card payments, you should consider determining that it has adequately addressed any contractual prohibitions against surcharges. You also should consider the effect of the use of a credit card processing company and electronically transmitted data on the government's internal control over financial reporting for those revenues.

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- Automotive fuel prices rose dramatically last year, and as soon as those prices began to abate in the late summer of 2000, natural gas, heating oil, and electricity prices began to rise. You should consider whether and how the past year's fuel and electricity price issues affect the financial statements of the governments you audit.
 - According to survey results from various health care consulting firms, employers experienced significant health care cost increases in 2000 and even higher increases are expected in 2001. When auditing a government that self-insures employee and retiree health care plans, you should consider the need to closely evaluate whether the estimated claims liability appropriately considers rising health care costs.
 - Government-specific loss data can help the governments you audit better estimate their risk exposure liabilities, thus potentially reducing audit effort in evaluating those estimates. The PRDP has introduced a Web-accessible database designed to be the nation's primary source of public entity loss information and reports.
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Regulatory, Legislative, and Other Developments

Single Audit Guidance Update

What updates to single audit guidance from federal agencies should auditors know about?

2001 Compliance Supplement Issued

The Office of Management and Budget (OMB) Circular A-133 *Compliance Supplement* (the Supplement) is based on the requirements of the Single Audit Act Amendments of 1996 (the Act) and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133). These requirements provide for the issuance of a compliance supplement to assist auditors in planning and performing the required audits. The Supplement identifies existing compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Act and Circular A-133.

Keeping its commitment to update the Supplement on a regular basis and to continue to expand the number of programs it includes,

the OMB has issued its March 2001 Supplement. For the 156 federal programs in the 2001 Supplement, information is included to help you understand the programs' objectives, procedures, and compliance requirements. Part 7 of the Supplement, "Guidance for Auditing Programs Not Included in This Compliance Supplement," provides guidance to help you determine relevant compliance requirements, audit objectives, and suggested audit procedures for programs not included in the Supplement. The 2001 Supplement adds sixteen federal programs (some of which result in new or add to existing program clusters) and updates and revises the information on numerous previously included programs and program clusters. The 2001 Supplement is effective for audits of fiscal years beginning after June 30, 2000.

Appendix V of the Supplement lists changes from the 2000 Supplement. Among the more significant changes, the 2001 Supplement—

- Adds audit objectives and suggested audit procedures for internal control for each of the fourteen types of compliance requirements in part 3, "Compliance Requirements." This change is to alert the auditor to the Circular A-133 requirements for testing internal control, responding to findings by Inspectors General in quality control reviews that many auditors have not properly documented the required testing of internal control. (See also "Circular A-133 Audit Reviews" and "Circular A-133 Audit Internal Control Refresher" later in this section of this Audit Risk Alert.) Changes were made elsewhere in the 2001 Supplement to refer to this new material.
- Updates, in part 3, the "Allowable Costs/Cost Principles" compliance requirement for facilities and administrative rate proposals based on the change to OMB Circular A-21, *Cost Principles for Educational Institutions*, as discussed in "OMB Cost and Grants Administration Circulars" later in this section of this Audit Risk Alert. Part 3 also clarifies the reference to state policies and nonfederal funds in the "Procurement and Suspension and Debarment" compliance requirement.
- Revises, in parts 4 and 5, the program requirements for many existing programs for the effect of new laws and regulations

or for other reasons. Substantial revisions are made to the program requirements for many Catalog of Federal Domestic Assistance (CFDA) programs, among them (1) 14.855, “Section 8 Rental Voucher Program,” and 14.857, “Section 8 Rental Certificate Program (previously the Section 8 Tenant-Based Cluster, but now combined into 14.871, “Section 8 Housing Choice Voucher”); (2) 17.253, “Welfare-to-Work Grants to States and Localities;” (3) 84.027, “Special Education—Grants to States (IDEA, Part B)” and 84.173, “Special Education—Preschool Grants (IDEA Preschool),” which form the Special Education Cluster; (4) 84.126, “Rehabilitation Services—Vocational Rehabilitation Grants to States;” (5) 93.210, “Tribal Self-Governance Demonstration Program: Planning and Negotiation Cooperative Agreements and HIS Compacts;” and (6) 93.558, “Temporary Assistance for Needy Families (TANF).”

- Updates appendix I, “Federal Programs Excluded From the A-102 Common Rule,” to remove U.S. Department of Agriculture entitlement programs, which are now subject to that common rule as discussed in “OMB Cost and Grants Administration Circulars” later in this section of this Audit Risk Alert.

Section .525(c)(2) of Circular A-133 permits federal agencies, with the concurrence of the OMB, to identify federal programs that are higher risk. The OMB provides this identification in appendix IV of the Supplement. The only programs for which such a higher risk designation has been made continues to be the Medicaid Cluster of the U.S. Department of Health and Human Services (HHS).

Help Desk—You may purchase the 2001 Supplement from the Government Printing Office or download a free electronic copy from the OMB Web site at www.whitehouse.gov/OMB/grants. (See the section entitled “References for Additional Guidance” at the end of this Audit Risk Alert.)

Data Collection Form Revision and Electronic Submissions

The Federal Audit Clearinghouse (FAC) collects information about Circular A-133 audits on a data collection form for entry into a data-

base that it maintains on its Web site. The OMB recently issued a revised form and accompanying instructions to report the results of Circular A-133 audits *for audit periods ending on or after January 1, 2001*. The OMB revised the form's part I, General Information, which the auditee completes, and part III, Federal Programs, which the auditor completes, to address many of the persistent problems that have caused rejections of submitted forms and to provide better information to the FAC and other federal agencies. Audits covering fiscal period end dates before January 1, 2001, should continue to use the previous version of the data collection form dated August 1997.

Help Desk—You can complete and submit the new and previous data collection forms electronically at the FAC Web site at harvester.census.gov/sac, as discussed later in this section. The data collection forms and related instructions also are available in portable document format (PDF) at the FAC Web site. You can obtain printed copies from the FAC by calling (888) 222-9907. When ordering printed copies by phone, note that the form number is SF-SAC and that you will need to indicate whether you need the new or previous form. You and the governments you audit are not permitted to create your own version of the forms.

Following are the revisions made in the data collection form.

- *Multiple Employer Identification Numbers (EINs) (part I, item 5(c), of the new form)*. The OMB added this item to require the auditee to complete an additional page (page 4) to provide the multiple EINs, if any, covered in the report. Previously, auditees indicated on the form whether they had multiple EINs, but they did not have to provide a listing of the additional EINs.
- *Cognizant and Oversight Agencies for Audit (part I, items 8 and 9, of the new form)*. The OMB simplified the questions relating to identifying a cognizant or oversight agency for audit. The form now requires only auditees with more than \$25 million in federal awards to identify their cognizant agencies. The OMB no longer asks auditees to identify the oversight agency for audit; the FAC will determine the over-

sight agency for audit from other information provided on the form.

- *Other Entities (part III, item 2, of the new form).* The OMB added a question to ask if the auditor's report includes a statement that the auditee's financial statements include departments, agencies, or other entities that had a separate Circular A-133 audit that is not included in the auditee's Circular A-133 audit, as required by AICPA Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, paragraph 10.54. In addition, in the form's instructions, the OMB clarified that an auditee should not submit a reporting package or data collection form if it is included in another entity's Circular A-133 audit report. For example, a university that is included in a state's single audit report and data collection form should not submit a separate reporting package or data collection form.
- *Reportable Conditions and Material Weaknesses (part III, items 5 and 6, of the new form) and Questioned Costs (part III, item 7, of the new form).* The OMB added three questions to ask if there were any reportable conditions, material weaknesses, or known questioned costs reported in the Circular A-133 audit. By asking these questions once for all programs, the OMB was able to delete the items on the previous form that required that information for each federal program.
- *Audit Findings (part III, item 8, of the new form).* The OMB added a question to ask whether a summary schedule of prior audit findings was prepared. This replaced the question on the previous form that asked whether any audit findings were required to be reported under section 510(a) of Circular A-133.
- *Number of Reports to Submit (part III, item 9, of the new form).* With the previous form, there was confusion in completing the item that asked which federal agencies were required to receive the reporting package. The OMB clarified this issue in the new form by asking the auditor to indicate which federal agencies have current-year audit findings related to di-

rect funding or prior audit findings (shown in the summary schedule of prior audit findings) related to direct funding. In addition, item 9 asks the auditor to indicate the total number of reporting packages to be submitted. The OMB now requires that auditees provide a copy of their reporting package to the cognizant agency for audit if it is not otherwise receiving one because of current- or prior-year audit findings related to direct funding.

- *Federal Awards Expended (part III, item 10, of the new form).* The OMB made several changes to the form's listing of federal awards expended (previously part III, item 6). The CFDA column now requires the auditor to break out the federal agency two-digit prefix and the three-digit CFDA program extension number into two fields. The prefixes are included in appendix I of the form's instructions and, in most cases, are the first two digits in the CFDA number. The OMB added fields to the form for the auditor to indicate whether the awards are part of the research and development cluster and whether the awards are received directly from federal entities or indirectly from pass-through entities. Further, as discussed earlier, the OMB deleted the columns for the amount of questioned costs and internal control findings.

The OMB made corresponding changes in the instructions for the data collection form. The instructions now include various examples to help auditees and auditors properly answer some of the new and complicated questions. The new instructions also encourage the online submission of the form.

As we reported in last year's Audit Risk Alert, the FAC now permits online submissions of the data collection form on its Web site in a system called the Internet Data Entry System (IDES). The FAC wants auditors and auditees to increase their use of the IDES. The FAC has received only about 10 percent of fiscal year 2000 data collection forms through the IDES.

The IDES allows you and your auditees to complete your portions of the data collection form online, directly into the system, and to benefit from online edits on the data entered in most items before

submitting the form. In fact, the IDES does not permit the form to be submitted online if there are unresolved edit failures. Although the form is submitted electronically through this process, it still needs to be printed, signed, and dated by the auditee and auditor, and mailed to the FAC with the appropriate number of audit reporting packages. Because the IDES benefits both the preparers of the data collection form and the federal government, OMB strongly encourages its use.

Early in 2001, the FAC made changes to the IDES so that it will accept data from the data collection forms of all nonfederal entities. Previously, the online form could accept a maximum of forty programs or contracts in the form's listing of federal awards expended. The number of program lines that can be entered is now unlimited if you upload the data to the system from a spreadsheet file. The IDES accepts online submissions using both the new and the previous forms, depending on the audit period for which the results of the Circular A-133 are being reported. You also can upload a large number of EINs, which are required on the new form, to the system from a spreadsheet file.

Reports filed using the IDES have experienced a rejection rate of less than 6 percent, as compared to a rejection rate of over 20 percent in non-IDES submission. The largest cause of errors in IDES submission is failure to include all the parts of the reporting package with the data collection form. Other rejections of IDES submission result from not signing or dating the form; listing multiple CFDA programs on one line; entering a program name as "none;" and printing the form in draft mode or using "print screen," which cuts off part of the fields, instead of following the submit and print instructions.

Federal Grant Streamlining Program

What is the Federal Grant Streamlining Program?

The Federal Grant Streamlining Program (FGSP) is the force underlying many current and potential future changes in single audit processes. The program is the result of the Federal Financial Assistance Management Improvement Act of 1999 (Public Law 106-107), which requires each federal agency to develop and implement a plan to streamline and simplify the application, administrative, and

reporting procedures for federal financial assistance programs. The Act also requires the agencies to consult with representatives of non-federal entities while developing and implementing their plans. The lead organization in the FGSP is the U.S. Chief Financial Officers (CFO) Council's Grants Management Committee (the Committee).

Each federal agency is required to develop an initial action plan to implement the Act by May 20, 2001. Early this year, twenty-three federal agencies—through the efforts of the Committee jointly published a request for comment on a draft action plan in the January 17, 2001, Federal Register (66 FR 4584). The proposed action plan describes the Committee's structure, goals, and accomplishments expected through May 2001 and how the Committee will be used to provide an ongoing, coordinated interagency effort to implement the Act.

Help Desk—You can access ongoing information about the FGSP progress on the U.S. Chief Financial Officers Council's Web site at financenet.gov/financenet/fed/cfo/grants/grants.htm.

Circular A-133 Audit Reviews

What are the results of recent reviews relating to the quality of Circular A-133 audits?

It has been several years since the major overhaul to single audit rules. To obtain more information about the Circular A-133 audits of the grants they administer, many federal Offices of Inspectors General (OIGs) and state-level agencies with oversight responsibilities for Circular A-133 audits are increasing their scrutiny of completed audits through desk reviews, quality control reviews, and other types of examinations.

Help Desk—Among the tools that OIGs use to perform desk reviews and quality control reviews are two checklists from the President's Council on Integrity and Efficiency (PCIE)—the *Uniform Guide for Initial Review of A-133 Audit Reports* and the *Uniform Quality Control Review Guide for A-133 Audits*. Copies of those guides are available on the Internet at www.ignet.gov/pande/audit/psingle.html. Before completing your Circular A-133 audits, consider reviewing the guides to gain an understanding of what the OIGs will be looking for in

their reviews. Taking this step will help ensure that your engagements meet the criteria identified.

In last year's Audit Risk Alert, we discussed various areas of Circular A-133 audits that appeared to need improvement. This year, we have two formal reports, as well as continued informal feedback, to discuss. Notable among the problem areas identified in the feedback over the past two years are sample sizes that appear too small, a lack of required documentation, and a failure to perform (or perhaps to document) required internal control and compliance work, although various other problem areas are evident. You should consider reviewing your own Circular A-133 audits to see whether they might include these kinds of issues. (See also "Circular A-133 Audit Internal Control Refresher" later in this section and "Common Engagement Deficiencies" in a later section in this Audit Risk Alert.)

HHS OIG Review of FAC Database. The FAC database of data collection forms allows federal agencies to easily identify possible errors in Circular A-133 audits for audit quality follow-up and possible referral for substandard work. The HHS OIG recently informed the AICPA and other audit organizations of the results of a review it performed on that database. The OIG reviewed the 1997, 1998, and 1999 submissions of certain targeted local governments, as well as a random sample of all nonfederal agencies receiving direct funding from HHS, to identify potentially substandard audits. The following list highlights some of the problem areas the OIG identified.

- Circular A-133 requires a type A program to be audited as a major program unless it qualifies as a low-risk program. Section .520(c) of the Circular states that for a type A program to be considered low risk, it must, among other criteria, have been audited as a major program in at least one of the two most recent audit periods. A significant number of type A programs that did not qualify as low-risk programs in 1999 because they had not been audited as major in 1997 or 1998 were not audited as major programs in 1999. Every type A program that was not audited in one of the prior two years is required to be audited as a major program

in the current year. If a type A program is new to an entity in the current year (for example, because the entity did not previously participate in the program or because it is a new federal program), it must be audited as a major program in the current year because it was not audited in one of the prior two years. If a program that previously was a low-risk type B program is a type A program in the current year (for example, because the funding level increased), and the program was not audited as a major program in one of the two prior years, it must be audited as a major program in the current year.

- There were a significant number of errors in identifying programs as part of a program cluster. Certain federal programs with different CFDA numbers are defined as a cluster of programs in part V of the Supplement because they are closely related programs and share common compliance requirements. Circular A-133 requires a cluster of programs to be considered one program (separately identified from the individual programs in the cluster) for purposes of determining major programs.
- Finally, there were significant errors in the audits' compliance with Circular A-133's percentage-of-coverage requirement. Circular A-133, section .520(f), requires an auditor to audit as major programs enough federal programs so that federal awards expended, in the aggregate, encompass at least 50 percent of total federal awards expended. If the auditee meets the criteria in Circular A-133, section .530, for a low-risk auditee, the auditor need only audit as major programs federal programs with federal awards expended that, in the aggregate, encompass at least 25 percent of total federal awards expended.

The HHS OIG plans to further investigate its findings by reviewing individual reporting packages, to discuss apparent deficiencies with the auditors and, when appropriate, to refer the audits for consideration to state boards of accountancy and the AICPA. It also plans to expand its review activities to examine the submissions of other nonfederal agencies receiving HHS funding.

Commerce OIG Review of FAC Database. In July 2000, the OIG of the U.S. Department of Commerce issued an agreed-upon procedures report on its evaluation of the FAC database, the results of which indicate that the information in the database is generally reliable. However, the Commerce OIG found significant errors in the following.

- Auditees incorrectly indicated on the data collection form (1) a cognizant agency when they had \$25 million or less in federal awards expended or (2) an oversight agency for audit if they had more than \$25 million in federal awards expended.
- Auditors identified on the data collection form federal agencies to receive the reporting package when there were no current-year findings related to funding provided *directly* by the federal agency or prior-year findings in the summary schedule of prior audit findings related to funding provided *directly* by the federal agency.
- Auditors indicated data elements in the summary of the auditor's results in the schedule of findings and questioned costs that were inconsistent with information in the auditor's reports or data collection form. Incorrect data elements in the summary of the auditor's results included the types of audit reports on the financial statements and on major program compliance (that is, unqualified, qualified, adverse, or disclaimer of opinion); the presence of reportable conditions, material weaknesses, or material noncompliance; the dollar threshold to distinguish between type A and type B programs; and whether the auditee qualified as a low-risk auditee.

The errors described in the first two bullets should be alleviated or eliminated by changes in the data collection form as discussed earlier in this section of this Audit Risk Alert entitled "Data Collection Form Revision and Electronic Submissions." Concerning the errors described in the last bullet, auditors should carefully review the summary of the auditor's results before submission to make sure that its data is consistent with information in the auditor's reports and data collection form.

Help Desk—You can obtain a copy of the OIG’s agreed-upon procedures report, entitled *Agreed-Upon Procedures and Results Assessment of Federal Audit Clearinghouse Database Fiscal Year 1998 Audit Reports*, on the Internet at www.oig.doc.gov/reports/2000-9/2000-9-122556-01.pdf.

Informal Feedback. In last year’s Audit Risk Alert, we reported that several OIGs believed the areas in the following list, among others, needed improvement. (See last year’s Audit Risk Alert for details about these areas and discussion of additional areas.) Informal feedback from OIGs as well as from state-level oversight agencies indicates that many of these continue to be problem areas.

- Working papers do not include adequate documentation of the auditor’s reasons for concluding that a type B program is low risk, the basis for audit procedures performed on internal control over compliance and how those procedures relate to a low assessed level of control risk, which audit tests are tests of internal control versus tests of compliance, and the required follow up on prior-year findings.
- Federal programs are identified as type A or B based on budgeted or appropriated expenditure amounts instead of actual expenditures as required by Circular A-133.
- Testing is performed on internal control over financial reporting, but not on internal control over compliance for federal programs.
- The tests performed by the auditor do not appear to be related to the applicable audit objectives identified in the Supplement. (This year, we were told that some auditors are still testing compliance requirements that existed before Circular A-133 was revised, rather than the fourteen types of compliance requirements provided in the Supplement. We also were told about the inadequate testing of allocability of employee costs among programs. When employees split their time between or among programs, the auditor should consider testing that those costs were allocated to major programs based on benefits received, in accordance with the OMB cost principles circulars.)

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- The working papers do not include documentation of the sampling plan and methodology, the basis for sample size, rationale for item selection, analysis of exceptions, or conclusions. (This year, we continued to hear reviewers comment on inadequate sample sizes for compliance tests, especially where there has been no testing of internal control over compliance.)
 - Auditors are including reportable audit findings in their management letter instead of in the schedule of findings and questioned costs.

Circular A-133 Audit Internal Control Refresher

What are the requirements of Circular A-133 relating to internal control?

As discussed in the previous section as well as elsewhere in this Audit Risk Alert, various organizations that monitor the quality of Circular A-133 audits are identifying problem areas that include the Circular's internal control requirements. To complement that discussion, we present this "refresher" on certain of the internal control requirements of Circular A-133. Auditors also should refer to Circular A-133, the Supplement, the General Accounting Office's (GAO's) 1994 *Government Auditing Standards*, as amended (also known as the Yellow Book), and chapter 8 of SOP 98-3 for the underlying requirements. (You also may want to consider referring to those sources to refresh yourself on the Circular A-133 requirements concerning applying materiality, selecting major programs, compliance testing, and reporting.)

Circular A-133 Internal Control Requirements. In addition to the consideration of internal control over financial reporting required by generally accepted auditing standards (GAAS) and the Yellow Book, Circular A-133 requires auditors to perform procedures to obtain an understanding of internal control pertaining to the compliance requirements for federal programs. That understanding has to be sufficient to plan the audit to support a low assessed level of control risk for major programs. Procedures to obtain an understanding have to be applied only to the applicable compliance requirements, from among the fourteen types of compliance requirements provided in the Supplement, that could have

a direct and material effect on the major programs. Further, Circular A-133 requires auditors to plan and perform tests of internal control over compliance to evaluate the effectiveness of controls unless the internal control is likely to be ineffective in preventing or detecting noncompliance with those requirements.

If the auditor determines that internal control is likely to be ineffective in preventing or detecting noncompliance, Circular A-133 requires the auditor to (1) assess control risk at maximum, (2) consider the effect of the ineffective control on the extent of substantive compliance testing, and (3) report a reportable condition or material weakness as an audit finding.¹

In performing tests of internal control over compliance, the evidential matter that would be sufficient to support a low assessed level of control risk is a matter of professional judgment. In evaluating the results of tests of controls, the auditor may find that the controls do not support a low assessed level of control risk. In this situation, the auditor is not required to expand testing of internal control over compliance; he or she may choose to assess control risk at other than low, design the extent of compliance testing accordingly, and consider the need to report an audit finding. On the other hand, the auditor may decide to expand the testing of internal control over compliance if he or she believes that expanded internal control testing would support a reduced assessed level of control risk and be more efficient than additional tests of compliance.

Level of Internal Control Consideration. In applying the provisions of Circular A-133, ineffective internal control relates to individual compliance requirements for each major program. For example, controls over eligibility requirements may be ineffective because access to participant eligibility records is not limited to appropriate

1. For the purpose of reporting internal control audit findings in accordance with the Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, reportable conditions and material weaknesses are evaluated at a level lower than the major program level—they are evaluated in relation to a type of compliance requirement for a major program or an audit objective identified in the OMB Circular A-133 *Compliance Supplement*. Also, reportable conditions may individually or cumulatively be material weaknesses, whether for purposes of reporting internal control over compliance or internal control over financial reporting.

persons and there is no review or reperformance of eligibility determinations. The entity may, nonetheless, have sufficient controls over allowable costs. In this case, the auditor would be required to plan and perform tests of controls over allowable costs and to report a reportable condition for the lack of control related to eligibility (including whether such condition is a material weakness) as part of the audit findings and in the auditor's report on internal control over compliance. The auditor in this example also would be required to assess the extent of procedures designed to test compliance with eligibility requirements. In most cases, the extent of that testing would need to be expanded.

Because reportable conditions and material weaknesses for the purpose of reporting audit findings in accordance with Circular A-133 are in relation to a type of compliance requirement for a major program or an audit objective identified in the Supplement, the auditor may not be required to report an audit finding if a control that is likely to be ineffective is not material at either of those levels. For example, for the program income type of compliance requirement, auditees must comply with requirements that specify the use of income that is directly generated by a program during the grant period. The audit objective identified in the Supplement is to determine whether program income is correctly recorded and used in accordance with the program requirements, the Circular A-102 Common Rule, and Circular A-110, as applicable. Suppose that an auditor assesses the control risk for an auditee's internal control over program income at the auditee's headquarters location as low, but finds that the internal control over program income at a satellite location is likely to be ineffective. However, the extent of program activities conducted at the satellite location, including those that generate program income, are not material to the type of compliance requirement. In this situation, the auditor could conclude that the lack of control over program income requirements at the satellite location does not constitute a reportable condition for the purpose of reporting an audit finding.

Auditor Responsibility for Nonmajor Programs. The auditor has no responsibility under Circular A-133 to obtain an understanding of internal control or to plan or perform any tests of controls over federal programs that are not determined to be major, except as may be

necessary to follow up on prior audit findings as required under Circular A-133, section .500(e).

Documentation. The auditor should thoroughly document his or her work in assessing control risk and in testing internal control. The auditor should note that *Government Auditing Standards*, paragraph 4.37, requires the working papers to contain documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records.

Help Desk—You may have been performing Circular A-133 audits for several years and may not be aware that you have developed audit processes and procedures that are not fully in accordance with the Circular and SOP 98-3. Taking (or retaking) a training session on Circular A-133 audit requirements may be an efficient and effective way for you to identify areas in which you need to improve your audits. The AICPA offers group-study and self-study continuing professional education courses on Circular A-133 audits. See the section entitled “References for Additional Guidance” at the end of this Audit Risk Alert for more information on those courses. You also may want to consider consulting the AICPA’s Practice Aid, *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133*, Audits of States, Local Governments, and Non-Profit Organizations, for practical guidance (as discussed at “AICPA Single Audit Guidance” later in this section of this Audit Risk Alert).

Orange Book

What is the status of the federal government's update of the Orange Book?

The PCIE hopes to issue a revision of *Federal Cognizant Agency Audit Organization Guidelines*, also known as the “Orange Book,” later in 2001. The Orange Book, originally issued in 1985, sets forth the responsibilities of the cognizant agencies for audit, addressing such areas as technical advice and liaison, desk reviews of audit reports, reviews of audit organizations and their work, dealing with deficiencies noted during reviews, and processing audit reports. The revision will consider, among other things, the effects of the Single Audit Act Amendments of 1996 and Circular A-133. The revision

also is expected to provide guidance to oversight agencies for audit as well as to the cognizant agencies.

Help Desk—When issued, the Orange Book should be available on IGnet, the Inspectors General Web site, at www.ignet.gov. You should consider reviewing the Orange Book to gain an understanding of IGs' processes and how they could affect your engagements.

AICPA Single Audit Guidance

Has the AICPA released any new or updated single audit guidance?

The AICPA recently issued a new edition of its nonauthoritative Circular A-133 Practice Aid, *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133*, Audits of States, Local Governments, and Non-Profit Organizations. The Practice Aid includes comprehensive analyses of, as well as the latest guidance on, applying Circular A-133. It also includes reference materials, audit checklists, illustrative examples, and a case study that will help auditors perform audits that comply with regulations.

Help Desk—To order the new edition of the Practice Aid (Product No. 006607kk), contact the AICPA Order Department at (888) 777-7077 or go to the AICPA Web site at www.aicpa.org.

We also have updated the AICPA's unofficial frequently asked questions regarding Circular A-133 for an inquiry received frequently in the past year relating to audit follow-up. Is the auditor responsible for following-up on prior-year Circular A-133 findings if in the current year the auditee expends less than \$300,000 in federal awards and is not subject to a Circular A-133 audit? The answer to this question is no, the auditor has no audit follow-up responsibility under Circular A-133 if the auditee is not subject to a Circular A-133 audit in the current year. However, if the current-year audit is being performed under *Government Auditing Standards*, the auditor would still be required to perform follow-up as required by paragraphs 4.7 through 4.11 of *Government Auditing Standards*. Those paragraphs include a requirement that the auditor follow up on known material findings and recommendations from previous audits that could affect the financial statement audit and report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

Help desk—The document of unofficial frequently asked questions and answers regarding Circular A-133 is on the AICPA Web site at www.aicpa.org/belt/a133main.htm. In addition to that Q&A document, that site has the illustrative auditor's reports, schedule of expenditures of federal awards, and schedule of findings and questioned costs from the appendixes of SOP 98-3.

OMB Cost and Grants Administration Circulars

Are there any recent or upcoming changes concerning the OMB's cost and grants administration circulars?

Circular A-21

If you audit a public college or university, you should be aware that the OMB amended Circular A-21, *Cost Principles for Educational Institutions* (published in the August 8, 2000, *Federal Register* [65 FR 48565]), to require that many colleges and universities submit their facilities and administrative (F&A) rate proposals in a standard format on or after July 1, 2001. The standard format does not apply to institutions that use the simplified method for calculating F&A rates as described in section H of Circular A-21. Also, a cognizant agency for indirect cost rate negotiation is able to grant individual institutions exceptions from the standard format requirement.

The standard format for F&A rate proposals, which is appendix C of Circular A-21, includes two parts: (1) a schedule of summary data on the institution's F&A cost pools and their allocations as well as the proposed F&A rates; and (2) a listing of supporting documents to be submitted with the proposal. The OMB believes that the standard format will help institutions more efficiently complete the indirect cost rate proposals, allow federal cognizant agencies to review those proposals on a more consistent basis, and help the federal government collect important data regarding F&A costs and rates at educational institutions.

Help desk—A recompilation of the entire Circular A-21 with all its amendments, including this amendment, is available on the OMB Web site at www.whitehouse.gov/omb/grants. Also available on that site is the OMB's Circular A-21 two-part memorandum.

In January 2001, the OMB issued a two-part memorandum entitled “Clarification of OMB A-21 Treatment of Voluntary Uncommitted Cost Sharing and Tuition Reimbursement Costs” to address certain complex issues relating to Circular A-21. The first part of the memorandum concerns voluntary uncommitted cost-sharing effort, which it defines as university faculty (including senior researchers) effort that is over and above what is committed and budgeted for in a sponsored agreement. The second part of the memorandum concerns how to handle tuition remission costs for graduate students who are engaged in federally supported research projects.

Circulars A-102 and A-110 Uniform Administrative Requirements

The U.S. Department of Agriculture (USDA) issued regulations in the August 14, 2000, *Federal Register* (65 FR 49474) to apply to its entitlement programs the uniform administrative requirements of Circular A-102, *Grants and Cooperative Agreements with State and Local Governments* (also known as the common rule), and Circular A-110, *Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations*. The USDA will incorporate the provisions of the rule into awards made after the start of the federal entitlement program year after the rule’s August 14, 2000, effective date.

The change affects all grantees that administer USDA entitlement programs, such as child nutrition and the food stamps program. (The regulations lists the specific programs affected.) However, there are some exceptions to applying the uniform administrative requirements for procurement and financial reporting to those entitlement programs. (As noted earlier in this section of the Alert entitled “2001 *Compliance Supplement* Issued,” the 2001 Supplement has been revised for the effects of this rule.)

The HHS also has proposed regulations (in the November 15, 2000, *Federal Register* [65 FR 68969]) to apply to its entitlement programs the Circular A-102 common rule. It proposes that the rule be applied prospectively to grants awarded after the effective date of the rule. The proposed rule lists specific programs that will

be affected by the change. The HHS has not proposed to adopt the exceptions adopted by the USDA regarding procurement and financial reporting requirements.

Cash Management Improvement Act Regulations

Are there any impending changes to the Cash Management Improvement Act regulations?

If you audit a state government, you should be alert to potential upcoming changes in its Treasury-State Agreement under the Cash Management Improvement Act of 1990 (CMIA). Last fall, the Treasury Department's Financial Management Service (FMS) issued a notice of proposed rulemaking to revise the regulations implementing the CMIA in the October 12, 2000, *Federal Register* (65 FR 60796). The CMIA regulations govern the transfer of funds between the federal government and the states for certain federal assistance programs and require an interest charge when one of the parties fails to make the transfer in a timely manner. (States and their subrecipients also are required by OMB grant administration circulars to minimize the time between transfers.) Compliance with Treasury-State Agreements under the CMIA is one of the audit objectives the Supplement lists for the cash management compliance requirement type.

Among its provisions, the proposed rulemaking would raise the default dollar thresholds that determine which programs are subject to the interest provisions of CMIA, thereby decreasing the number of programs covered. (A state could choose to retain a lower threshold to cover more programs.) The proposed rulemaking also would make Treasury-State Agreement effective until terminated (rather than for one to five years), establish a uniform format for the agreements, and eliminate restrictions on allowable funding techniques. Further, it would subject cost disallowances to the CMIA's interest provisions. The proposed rulemaking did not propose an effective date. The FMS will establish an effective date that considers the issuance date of the final rulemaking in relation to the states' fiscal year ends.

HUD Electronic Submission Requirements for Public Housing Authorities

What are the electronic submission requirements for public housing authorities, and what are the auditor's related responsibilities?

The U.S. Department of Housing and Urban Development (HUD) has Uniform Financial Reporting Standards (UFRS) for HUD housing programs that establish uniform annual financial reporting standards for HUD's public housing, section 8 housing, and multifamily insured housing programs. Those standards require public housing authorities (PHAs) and project owners of HUD-assisted housing to submit financial information electronically to HUD's Financial Assessment Subsystem (FASS) via a template known as the Financial Data Schedule (FDS). The Real Estate Assessment Center (REAC), which is the HUD national management center created to receive and evaluate electronic submissions, also requires certain auditor involvement with the electronically submitted information.

To identify auditors and enhance the security of its system, REAC recently instituted a system of "unique independent public accountant identifiers" (UIIs). For each PHA electronic submission after February 2, 2001, that has auditor involvement, FASS requires a UII, which is a randomly generated, permanently assigned, five-digit number. Before an auditor may obtain a UII, the auditor must register within HUD secure systems, which requires the involvement of an auditee. Therefore, you should coordinate with one of your PHA auditees to obtain your UII before you will need it.

To ensure accuracy and consistency of the data in FASS, the REAC requires—

- Audited annual basic financial statements prepared in conformity with generally accepted accounting principles (GAAP) for governmental entities, as prescribed by the GASB.
- Attestation by auditors on FDS data as to their "fair presentation in relation to audited basic financial statements" in accor-

dance with the audit provisions of SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551).

- A separate attestation agreed-upon procedures engagement under Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600), in which the auditor compares the PHA's electronically submitted data in the REAC staging database to the hard copy of the audit report and FDS. (The recently issued SSAE No. 10, *Attestation Standards: Revision and Recodification*, Chapter 2, "Agreed-Upon Procedures Engagements" [AICPA, *Professional Standards*, vol. 1, AT sec. 201], supersedes SSAE No. 4. See the discussion of SSAE No. 10 later in this Audit Risk Alert in the section entitled "Recent Attestation Standards." HUD is expected to revise its guidance to refer to the new SSAE when it becomes effective for periods beginning on or after June 1, 2001.)

A PHA must submit its preliminary FDS electronically within two months after its fiscal year end based on unaudited information. No auditor involvement is necessary for that unaudited submission. A final FDS based on audited financial statements must be electronically submitted within nine months after a PHA's fiscal year end. It is this final submission on which the auditor performs a separate attestation agreed-upon procedures engagement. To report, the auditor completes the appropriate agreed-upon procedures report template in the FASS and submits it electronically to HUD. REAC has issued a document entitled *Guidelines on Reporting and Attestation Requirements of Uniform Financial Reporting Standards—March 2001* (the Guidelines), which provides guidance on the detailed requirements for electronic submission and the auditor's involvement in the process.

Effective for electronic submissions and resubmissions after January 1, 2001, PHAs also are required to electronically submit (1) the auditor's reports (including the Circular A-133 and Yellow Book reports) and (2) the associated top-level (basic) financial statements

(which are a financial position statement, a statement of operating results, and, if applicable, a statement of cash flows) as well as the notes to the financial statements. REAC has revised the Guidelines for this change.

PHAs that are not subject to Circular A-133 because they expend less than \$300,000 of federal awards are not subject to audit requirements under the UFRS. However, they still are required to electronically submit unaudited data.

Help Desk—The AICPA provided input into the Guidelines as HUD developed them, particularly on the agreed-upon procedures report templates. A copy of the Guidelines can be obtained from the REAC Web site at www.hud.gov/reac/pdf/ufrs22801.pdf. Additional information regarding the activities of REAC and how they affect HUD programs and audits of HUD programs is available on the REAC Web site at www.hud.gov/reac. Further assistance on the electronic submission requirements is available by contacting the REAC Customer Service Center at (888) 245-4860.

Government Auditing Standards

Are there any recent or upcoming revisions to Government Auditing Standards?

The GAO's 1994 *Government Auditing Standards*, as amended (also known as the Yellow Book), is the set of standards to follow when required by law, regulation, agreement, contract, or policy for the audits of various entities, including state and local governments. The Yellow Book standards are an integral part of the requirements for a Circular A-133 audit. The only amendments to the 1994 Yellow Book, which were issued in 1999, are *Amendment No. 1: Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems*, and *Amendment No. 2: Auditor Communications*. However, future changes are pending.

Help Desk—The GAO has codified the Yellow Book to include its two amendments. A printed copy of that updated Yellow Book codification is not available yet, but you can download a

free electronic version from the GAO Web site at www.gao.gov/govaud/ybk01.htm. You also can order printed copies of the two amendments or download free electronic versions. (See the section entitled “References for Additional Guidance” at the end of this Audit Risk Alert.)

Upcoming Proposals

The GAO is expected to issue an exposure draft (ED) soon to amend the Yellow Book standards concerning the independence of individuals and organizations that conduct financial and performance audits. The GAO issued a Preliminary Views (PV) document on the project in April 2000 to invite comments on possible revisions to the second general standard on independence and to add new related standards to reporting on financial and performance audits. The Advisory Council on Government Auditing Standards, the group that advises the GAO on changes to the Yellow Book, has considered the comments received on the PV and recommended that the GAO issue an ED on independence that would propose changes to the Yellow Book that differ significantly from those considered in the PV.

The primary independence issues that the PV considered were (1) how to define when auditors and evaluators and their organizations are independent and (2) whether and how an audit (or evaluator) organization that is not independent should issue an audit opinion on financial statements (or a report on a performance audit or evaluation) when required (or authorized) by law to do so. The ED is expected to cover the first of those two issues as well as to propose standards relating to the effect of scope of services on auditor independence. Scope of services addresses the types of additional services that an auditor or audit organization might provide (such as financial statement compilation, indirect cost plan preparation, or IT consulting) that would impair its independence for audit purposes. The PV’s focus on defining independence largely related to governmental auditors. However, the scope of services proposals expected to be added to the ED will be much broader and are likely to affect all auditors and their auditees.

The GAO also is expected to issue an “omnibus” ED in 2001 to propose changes to various other areas of the Yellow Book. The is-

sues addressed by that ED are expected to include additional standards for certain attestation engagements, a general standard on integrity, and revised field work and reporting standards for performance audits.

Help Desk—When issued, the Yellow Book EDs will be available on the GAO Web site at www.gao.gov/govaud/ybk01.htm. Check the GAO Web site or watch future issues of the AICPA's *Journal of Accountancy* and *CPA Letter* for status updates.

Amendment No. 1 and No. 2 Implementation Issues

We want to alert you to a few issues arising from the issuance and implementation of Yellow Book Amendment No. 1 and No. 2. First, Amendment No. 1 established a new field work standard that requires certain information to be documented when financial data significantly depends upon computerized information systems. Specifically, the amendment requires auditors to document in the working papers both (1) the basis for assessing control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems; and (2) consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level. Some auditors of smaller governments tend to audit “around the computer” and should keep in mind that they need to include the documentation required by Amendment No. 1 in their working papers. Including the required documentation in the working papers will help ensure that you do not inadvertently rely on computer-generated evidence in conducting substantive tests. (See also the section later in this Audit Risk Alert entitled “Recent Auditing Standards” for a discussion of SAS No. 94, which amends and expands the discussion in SAS No. 55 of the auditor’s consideration of an entity’s use of IT in controls relevant to the audit.)

Second, Amendment No. 2 established a field work standard (by amending and expanding what previously had been a reporting standard) that requires auditors to communicate information to certain parties regarding the nature and extent of planned testing and

reporting on compliance with laws and regulations and internal control over financial reporting. Among the parties with whom the auditor should communicate are the audit committee or board of directors or other equivalent oversight body, in the absence of an audit committee. This communication must take place during the planning stages of the audit. Some auditors have been putting the required communication in the engagement letter. However, you should be aware that using that letter to make the required communication does not satisfy the amendment's field work standard if the letter is not delivered to the audit committee or board.

Finally, the 1994 Yellow Book required that when auditors report separately on compliance with laws and regulations and internal control over financial reporting, the report on the financial statements should state that they are issuing those additional reports. Amendment No. 2 added to that requirement, stating that when auditors issue separate reports on compliance with laws and regulations and internal control over financial reporting, the report on the financial statements should state that those reports are an integral part of a generally accepted government auditing standards audit, and in considering the results of the audit, those reports should be read along with the auditor's report on the financial statements. GAO staff members have told us that they have received questions about the effect of those requirements on an auditor's report on comparative financial statements. Specifically, should the auditor's report on the financial statements refer to the separate compliance and internal control reports for both the current and prior year? GAO staff members tell us that they have responded that such a "dual" reference is not needed (that is, auditors need only refer to the current-year separate reports). Those individuals are giving that answer because *Government Auditing Standards*, paragraph 4.10, requires auditors to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit and report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit. Therefore, referencing only the current-year compliance and internal control reports will direct the report user to sufficient information about the prior-year findings.

Passenger Facility Charge Audit Guide

Has the Federal Aviation Administration issued its revised Passenger Facility Charge Program audit guide?

Passenger facility charges (PFCs) are \$1 to \$4.50 fees that are authorized by Congress and charged by commercial airports after receiving approval from the Federal Aviation Administration (FAA) under 14 Code of Federal Regulations (CFR), part 158, “Passenger Facility Charges.” The airlines collect these fees from airline passengers and submit them to the appropriate airports, which use them for approved airport projects. If you audit a public airport, you should note that the FAA revised its audit guide, *Passenger Facility Charge Audit Guide for Public Agencies*, as of September 2000. Among other things, the revised guide provides you with a comprehensive set of procedures for auditing a public airport’s PFCs in accordance with the requirements of 14 CFR 158. The revision updates the previous guide for the Single Audit Act Amendments of 1996, the 1997 revisions to Circular A-133, and *Government Auditing Standards* Amendment No. 1 and No. 2. The revision also clarifies the scope of a PFC audit.

When engaged to audit PFC accounts, you are required, among other things, to report on the fairness and reasonableness of the airport’s procedures for receiving, holding, and using PFC revenues. PFC regulations allow the PFC audit to be performed as a separate audit or as part of an audit under the Single Audit Act Amendments of 1996. The guide revision clarifies that, under the second option, PFCs are not considered to be federal awards as defined by Circular A-133,² and that the specific provisions of that Circular and related documents, such as the Supplement and the data collection form, do not apply to the PFC program. Further, due to inconsistencies between the PFC program and the requirements of Circular A-133, PFC funds and related findings and questioned costs should be reported separately from the schedule of expendi-

2. If passenger facility charges (PFCs) are audited as part of the Circular A-133 audit, the PFCs should not be considered federal awards expended in determining major programs or computing the percentage-of-coverage rule.

tures of federal awards and findings and questioned costs reported for the Circular A-133 audit. Auditors should report on the separate schedule of PFC expenditures in relation to the airport's financial statements taken as a whole.

Help Desk—The Web site address for the FAA Office of Airports PFC Branch, which is responsible for developing policy and procedures associated with the implementation of the PFC program by airports, airlines, and the FAA, is www.faa.gov/arp/530home.htm. The PFC guide is at that site.

Electronic Contracts and Signatures

Does federal and state legislation now permit electronic contracts and signatures?

Many organizations, including governments, conduct a substantial and fast-growing amount of business over the Internet. The federal government and various state governments are enacting legislation to remove barriers to e-commerce by addressing the legality of electronic contracts and signatures. The governments you audit may be changing certain of their processes and installing new IT systems because of those legislative changes. Some of those processes and systems may affect the structure of a government's transactions as well as internal control over financial reporting, requiring changes in your audit approach. (See also the discussion of SAS No. 94, which amends and expands the discussion in SAS No. 55 of the auditor's consideration of an entity's use of IT in controls relevant to the audit, later in this Audit Risk Alert in the section entitled "Recent Auditing Standards.")

Enacted in June 2000, the Electronic Signatures in Global and National Commerce Act (Public Law 106-229) enhances the legal certainty for much e-commerce in or affecting interstate or foreign commerce. The Act extends the same legal weight granted contracts signed on paper to many transactions sealed with an "electronic signature"—a secure code transmitted electronically. The Act permits state laws and regulations that constitute an enactment of the Uniform Electronic Transactions Act (UETA) to provide alternative procedures or requirements for the use or

acceptance of electronic records and signatures in many cases. UETA is a uniform legal framework adopted by the National Conference of Commissioners on Uniform State Laws in 1999. Like the federal Act, the primary objective of the UETA is to make electronic records and signatures legally equivalent to paper writings and manually signed signatures. Over twenty states have adopted the UETA and another dozen may consider it during their 2001 legislative sessions.

Three sections of UETA deal with electronic records that state governments create and retain. Those sections allow a state to designate one agency or officer (1) as the authority on creation and retention of governmental records, (2) to regulate the communication of electronic records and use of electronic signatures between agencies and other persons, and (3) to set standards that promote consistency and interoperability between state agencies with respect to the use of electronic records and signatures.

Help Desk—The UETA, a summary of its provisions, and a listing of the states that have adopted it and that are considering it are available on or through the Web site of the National Conference of Commissioners on Uniform State Laws at www.nccusl.org.

Supreme Court Ruling on Compensatory Time

What was the result of last year's Supreme Court case on the compensatory time policy of a governmental employer?

In May 2000, the Supreme Court issued a ruling (*Christensen et al. v. Harris County et al.*, No. 98-1167) concerning the policy of a governmental employer regarding compensatory time. A sheriff department's employees sued the employer county because its policy required them to schedule time off to reduce the amount of employees' accrued compensatory time. The employees claimed that the Fair Labor Standards Act of 1933 (FLSA) does not permit an employer to compel the use of compensatory time in the absence of an agreement permitting the employer to do so. However, the Supreme Court found the reverse—stating that nothing in the FLSA or its implementing regulations prohibits public employers from compelling employees to use compensatory time in lieu of

cash payments. Some of the governments you audit may experience reduced compensatory time balances because of policy changes resulting from this ruling.

Private-Activity Bonds

Is there any new federal legislation relating to private-activity bonds?

Private-activity bonds are tax-exempt debt issued by state and local governments, the proceeds of which are to be used for a private activity business use or to make or finance loans to certain persons. Private-activity bonds include obligations that are known as “exempt facility bonds,” mortgage bonds, veterans’ mortgage bonds, small issue bonds, student loan bonds, redevelopment bonds, and section 501(c)(3) bonds. Private-activity bonds are a significant part of the municipal debt market. More than \$440 billion in new and refunding private-activity bonds were issued from 1988 through 1995, representing more than 25 percent of all municipal debt issued during that period.

You may see the issuance of private-activity bonds rise in the future. Incorporated into the Consolidated Appropriations Act, 2001 (Public Law 106-554), the Community Renewal Tax Relief Act of 2000 increased the limit on tax-exempt private activity bonds from \$50 per capita/\$150 million per state to \$62.50 per capita/\$187.50 million per state in 2001, and to \$75 per capita/\$225 million per state in 2002. Subsequent increases will be indexed for inflation. States allocate portions of their volume caps to individual municipal issuers.

Internal Revenue Service Activities

Have there been any Internal Revenue Service developments that auditors of state and local governments should know about?

Tax Exempt and Government Entities Division

In last year’s Audit Risk Alert, we reported how, as part of its modernization plan, the Internal Revenue Service (IRS) created the Tax Exempt and Government Entities (TE/GE) Division. The Division has three segments to deal separately with exempt organiza-

tions, employee plans, and governmental entities. The Division addresses key customer needs by providing the following services:

- Education and communication efforts, which focus on helping customers understand their tax responsibilities with outreach programs and activities tailored to their specific needs
- Rulings and agreements efforts, which have a strong emphasis on up-front compliance programs such as the determination, voluntary compliance, and private letter ruling programs
- Examination initiatives, which identify and address noncompliance through customized activities within each customer segment
- Customer account services, which coordinates tax filings and responses to questions and requests for information

The IRS continues to develop the structure of its TE/GE Division. The Division's Governmental Entities segment has established offices of Federal, State, and Local Governments³ and Indian Tribal Governments and has incorporated the Tax Exempt Bonds program.

The IRS continues to develop a customer-friendly Web site at www.irs.gov. That site provides contact information for the leadership of the TE/GE Division and currently has separate pages to serve the customers of the Exempt Organizations and Employee Plans segments of the TE/GE Division. The IRS is developing a separate page for the Governmental Entities segment.

Federal Insurance Contribution Act Taxes

For the past few years, we have alerted you to how certain employees of many governments are now subject to full coverage under the Federal Insurance Corporation Act (FICA)—that is, Social Security and Medicare coverage—and how governments may be liable

3. One part of the Tax Exempt and Government Entities (TE/GE) Division's approach to meeting its mission is to solicit input from governments and professional and membership associations concerned with governments on outreach techniques and topics. Should you or the governments you audit have suggestions for the division in this regard, contact Allen Jones, the division's director of federal, state, and local governments, at (202) 283-9818 or allen.jones@irs.gov.

for past employment taxes that should have been paid. One FICA-related matter that is coming to the attention of the IRS and that may affect the governments you audit concerns lump-sum settlements to employees. Governments may make such settlements, for example, in connection with downsizing efforts. In many cases, those payments are considered wages subject to FICA coverage. If an employer fails to withhold FICA taxes from the payments, the employer remains liable for the taxes, although the employer has a legal right to recover the taxes paid from the employees.

Transportation Fringe Benefits

In the January 11, 2001, *Federal Register* (66 FR 2241), the IRS issued final regulations under Internal Revenue Code (IRC) section 132(f) to give guidance to employers that provide transportation fringe benefits to employees. The regulations establish monthly limits on the value of qualified transportation fringe benefits that is excludable from an employee's gross income. Qualified transportation fringe benefits consist of transportation in a commuter highway vehicle, any transit pass, and qualified parking provided by an employer to an employee. The amount by which the value of qualified transportation fringe benefits exceeds the applicable monthly limits should be included in the employee's wages for income and employment tax purposes.

Tax Exempt Bonds

The IRS's Tax Exempt Bonds program has become increasingly active during the past year. The program has started compliance reviews of tax-exempt debt issuances and has found significant problems in major areas, including private use and arbitrage (such as only 50 percent compliance with arbitrage rebate requirements in recent reviews). In the last year, the IRS has been negotiating closing agreements with a dozen or more issuers of tax-exempt debt over misuse of debt proceeds, which could require the issuers to pay significant monetary settlements. You should be alert to issues of noncompliance with federal requirements concerning tax-exempt debt because it could have a direct and material effect on an issuer's financial statements amounts. Because of the complexity of federal requirements in this area, you

should consider giving increased audit scrutiny to this area as well as consulting a tax-exempt debt specialist.

Congress passed the Energy Policy Act of 1992 to encourage the restructuring of the electric power industry. Since that time, the Federal Energy Regulatory Commission (FERC) and many states have adopted policies to open access to transmission facilities. (See the discussion related to electric deregulation earlier in this Audit Risk Alert in the section entitled “Fuel and Electricity Price Issues.”) As discussed in last year’s Audit Risk Alert, the IRS issued temporary regulations in the January 22, 1998, *Federal Register* (63 FR 3256), to provide guidance regarding the effect of certain restructuring transactions on the tax-exempt status of bonds issued to finance publicly owned utilities. Those temporary regulations were effective for three years.

The IRS published another set of temporary regulations relating to tax-exempt bonds issued to finance publicly owned utilities in the January 18, 2001, *Federal Register* (66 FR 4754), which again are effective for up to three years. In the same *Federal Register* (66 FR 4661), the IRS issued a notice of proposed rulemaking to adopt those temporary regulations as final. Although the 2001 regulations make several changes and clarifications to the 1998 regulations, they retain the basic thrust of the 1998 regulations. Among other things, the regulations provide that state and local governments may engage in the following activities without jeopardizing the tax-exempt status of the bonds: (1) allowing an independent operator to operate, manage, and run—but not own—transmission lines; (2) sell excess generating capacity by nonrenewable contracts to private entities for up to three years; and (3) enter into certain short-term contracts to supply power to private users. The 2001 regulations apply to new-issue bonds sold on or after January 19, 2001, although the provisions apply to certain refunding bonds sold on or after that date and all or certain of the provisions may be applied to bonds issued before that date.

Qualified Zone Academy Bonds

In the September 26, 2000, *Federal Register* (65 FR 57732), the IRS issued final regulations relating to Qualified Zone Academy Bonds

(QZABs). QZABs are taxable bonds used to benefit public schools located in enterprise communities or empowerment zones. The regulations apply to bonds sold on or after September 26, 2000.

The regulations clarify that, besides issuances by a state or local government, a nonprofit corporation may sell QZABs on behalf of a state or local government, allowing the issuance of the bonds without them being counted against the government's debt limit. Therefore, you may observe the governments you audit receiving financing from bonds they did not issue. Any issuer selling QZABs must stipulate that the funding will be matched at least 10 percent by a private entity, which the final regulations clarify is a corporation not affiliated with or related to the federal, state, or local government. The regulations also clarify that the private-entity contribution may be in the form of various types of property or services as specified in the regulations. Therefore, if a government you audit issues QZABs directly, you may want to consider whether these clarified requirements could have a direct and material effect on the determination of the entity's financial statement amounts.

Employee Benefit Plans

Employers With 403(b) and 457 Plans. The TE/GE Division's Employee Plans segment has a new initiative to examine employers that offer both IRC section 403(b) tax-sheltered annuities (403(b) plans) and IRC section 457 deferred compensation plans. That initiative would affect, for example, school districts, public colleges and universities, and governmental hospitals. As we reported in last year's Audit Risk Alert, past IRS examinations of 403(b) plans have uncovered many deficiencies, including excessive contribution limits; noncompliance with distribution requirements; inadequate salary reduction agreements; and failure to offer universal availability of salary reduction programs (because of impermissible eligibility restrictions, mandatory contributions, and participant exclusions). Those compliance deficiencies have resulted in sizeable assessments against employers to prevent the plans from being declared taxable to the employees. (Note that if the assessments had not been levied, not only would the employees have been subject to tax, but also the governmental sponsors could have been held liable for employees' unpaid tax and subjected to penalties for underreporting wages.)

You should be alert to potential liabilities that might arise in such situations and the heightened level of risk resulting from the known IRS initiative.

Help Desk—You may want to alert the governments you audit that an IRS audit of these plans can be a lengthy and laborious experience. You could share with your auditee the first-person account of a 403(b) plan audit that was published in the September 2000 *Members in Government* supplement to the AICPA's *CPA Letter*. That supplement is available on the AICPA Web site at www.aicpa.org/pubs/cpaltr/sep2000/supps/gov.htm.

Automatic Deferrals. The IRS issued Revenue Ruling 2000-33 (*Internal Revenue Bulletin* 2000-31, July 31, 2000) to specify the criteria that have to be met to automatically defer a certain percentage of an employee's compensation into a section 457 deferred compensation plan and Revenue Ruling 2000-35 (*Internal Revenue Bulletin* 2000-31, July 31, 2000) to specify the criteria for deferral into a 403(b) plan. These rulings address situations in which deferrals are made without an affirmative election by the employee to receive the amount in cash.

Administration of Section 457 Deferred Compensation Plans. The IRS has published information about the administration of section 457 deferred compensation plans. You may want to make sure that the governments you audit have considered that information. In Notice 2000-38 (*Internal Revenue Bulletin* 2000-33, August 14, 2000), the IRS describes the withholding and reporting requirements applicable to section 457(b) plans. In Notice 2000-66 (*Internal Revenue Bulletin* 2000-52, December 26, 2000), the IRS increased the limit on deferrals under section 457(b)(2) and (c)(1) from \$8,000 to \$8,500 effective January 1, 2001.

Employee Plans Compliance Resolution System. The IRS recently issued Revenue Procedure 2001-17 (*Internal Revenue Bulletin* 2001-7, February 12, 2001) to update and expand on its Employee Plans Compliance Resolution System (EPCRS). The EPCRS is a comprehensive set of corrective programs that enable sponsors of qualified retirement plans that have experienced compliance violations to preserve the tax benefits of their plans. Those programs apply to various qualified plans, including 403(b) plans. Effective

May 1, 2001, Revenue Procedure 2001-17 superseded Revenue Procedure 2000-16, which was the previous statement of the correction programs under EPCRS.

Educational Outreach. The TE/GE Division's Employee Plans segment has formalized its educational outreach program to increase understanding and compliance with the tax law applicable to 403(b) plans. It calls this program the Section 403(b) Tax-Sheltered Annuity Partnership for Compliance. Under the program, IRS employees are available to provide educational services relating to 403(b) plans, including delivering speeches, participating in panel discussions, conducting training sessions, and helping to prepare newsletter articles. If one of your auditees is concerned about the compliance of its 403(b) plan, you should consider referring it to the Partnership for Compliance.

Help Desk—You can access information about the Partnership for Compliance and request educational services on the IRS Web site at www.irs.gov/bus_info/ep/outreach.html.

Classification of Employees Versus Independent Contractors

In their efforts to reengineer and streamline operations, many governments are using independent contractors more frequently. The IRS has identified the “employee versus independent contractor classification” area as one with potentially significant compliance problems. Auditors should be alert to the potential financial statement effect that may arise from the inappropriate classification of independent contractors and the resulting tax liability. The IRS is continuing a nationwide Employment Tax Outreach Program begun in 1997 to increase compliance by requiring organizations, including state and local governmental entities, to properly classify workers either as independent contractors, subject to reporting payments of \$600 or more on Form 1099, or as employees, subject to withholding taxes on Form W-2. Employers classifying workers as employees must withhold federal income and FICA taxes from employees' pay and match the FICA taxes. Further, the reclassification of a worker from an independent contractor to employee for federal purposes is likely to cause a similar reclassification for state tax purposes.

There have been three significant developments regarding worker classification during the last several years. First, the IRS issued guidance to its agents to help them resolve questions regarding who is an employee and who is an independent contractor. Second, the Small Business Job Protection Act of 1996 (Public Law 104-188) modified section 530 of the Revenue Act of 1978, a relief provision sometimes invoked to enable individuals who are really employees to continue to be treated as independent contractors without consequence to employers. The changes made to section 530 were generally favorable to employers. Last, the IRS introduced a classification settlement program (CSP) to provide graduated settlement offers in situations in which section 530 relief may or may not be available but an employer has at least consistently reported the affected individuals as independent contractors. With the CSP, settlements may be 0 percent, 25 percent, or 100 percent of the assessment, depending on the strength of the employer's argument for section 530 relief. In addition, future compliance is required.

Payments to Attorneys

In last year's Audit Risk Alert, we discussed proposed IRS regulations to clarify the reporting requirements for those who make payments of gross proceeds in the course of a trade or business to attorneys in connection with legal services. IRS Notice 2001-07 (*Internal Revenue Bulletin* 2001-4, January 22, 2001) has extended the effective date of the proposed regulations until after final regulations are issued and indicate an effective date. Nevertheless, payments of gross proceeds to attorneys made after December 31, 1997, are and continue to be reportable on Form 1099-MISC pursuant to IRC section 6045(f). Taxpayers may use the proposed regulations as a safe harbor providing a reasonable interpretation of the statute.

IRS Considers Certain Governmental Entities Under Exempt Organizations Segment

Although subject to governmental accounting and auditing standards, the IRS considers certain governmental entities, such as colleges and universities and certain health care providers, to be

customers of the Exempt Organizations segment of the TE/GE Division, rather than customers of the Governmental Entities segment. Therefore, those entities and their auditors should consider also monitoring the actions of the Exempt Organizations segment to understand current, proposed, and potential future IRS actions that could affect them. Among the initiatives the Exempt Organizations segment has under consideration for this year are (1) continuing to examine higher education and health care entities for noncompliance with employment taxes, employee benefit plans, unrelated business income, and exemption issues, (2) issuing a report on inadequate recordkeeping and imposing penalties for incomplete returns, and (3) considering narrowing the scope of the IRS's proposed rules on the tax treatment of corporate sponsorship payments to exempt organizations. The Exempt Organizations segment issued Announcement 2001-14 (*Internal Revenue Bulletin* 2001-7, February 12, 2001) to request comments on a new initiative on outreach and education and on establishing voluntary compliance programs.

Help Desk—The EO's page on the IRS Web site is at www.irs.gov/bus_info/eo. You also may want to refer to two other annual AICPA Audit Risk Alerts—*Not-for-Profit Organizations Industry Developments* and *Health Care Industry Developments*—for IRS matters that concern primarily colleges and universities and health care organizations.

Securities and Exchange Commission Activities

Have there been any Securities and Exchange Commission developments that auditors of state and local governments should know about?

In the May 4, 2000, *Federal Register* (65 FR 25843), the Securities and Exchange Commission (SEC) published an Interpretation (Release No. 33-7049 and 34-33741) to provide guidance on the use of electronic media by issuers of all types, including municipal securities issuers.⁴ The Interpretation, which was effective when is-

4. Municipal securities are exempt from all of the provisions of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act) except the antifraud provisions of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act (and the associated Rule 10b-5). Those antifraud provisions prohibit any person from misrepresenting or omitting material facts in the offering or sale of securities.

sued, (1) updates SEC guidance on the use of electronic media to deliver documents under the federal securities law, (2) discusses an issuer's liability for Web site content, and (3) outlines the basic legal principles that issuers and market intermediaries should consider in conducting online offerings. The Interpretation also included a solicitation of comments on various technology issues that may affect future SEC rulemaking efforts.

The Interpretation observes the Internet's significant effect on the securities market, including the fact that municipal securities issuers are beginning to use the Internet to provide information about themselves, their outstanding bonds, and new securities offerings. (See also the section earlier in this Audit Risk Alert entitled "Emerging E-Government Applications.") The SEC believes that, although electronic media permits the rapid, cost-effective, and widespread dissemination of information, it presents the potential to defraud the investing public.

As discussed in the Interpretation, the SEC previously has issued guidance on the electronic delivery of information. The Interpretation clarifies, among other matters, that issuers and intermediaries may deliver documents in portable document format (PDF). It also clarifies that municipal securities underwriters may rely on a municipal securities issuer to identify which of the documents on, or hyperlinked from, the issuer's Web site constitute the preliminary, deemed final, and final official statements, even if that site contains other documents or hyperlinks to other sites. However, hyperlinks embedded within an official statement itself will be considered part of the official statement. Further, for municipal securities offerings subject to Rule 15c2-12 (17 CFR 240.15c2-12), the paper and electronic versions of each official statement must be the same. The Interpretation also identifies some situations in which an issuer's hyperlink to a third-party Web site results in the issuer having adopted that information for purposes of the anti-fraud provisions of the federal securities law.

The Interpretation clarifies the general legal principles that issuers, underwriters, and broker-dealers should consider when developing and implementing procedures for online public offerings. Although the Interpretation does not specifically address municipal securities

offerings in this regard, it cautions that those offerings also may involve the offering of a separate security that is not exempt from the registration requirements of the Securities Act of 1933.

Since the mid-1990s, the SEC has brought more than 100 enforcement actions under the federal securities laws in the area of municipal securities, many of them related to the antifraud provisions of those laws. You might want to consider advising the governments you audit about the SEC Interpretation and cautioning them that the SEC is now turning a more discerning eye to their Web sites to determine whether they have misrepresented or omitted material facts in the offering or sale of securities.

Help Desk—The SEC Interpretation is available on the SEC's Web site at www.sec.gov. Also available on that site are responses to the solicitation for comments that were electronically submitted. That site also includes a compendium of SEC actions on municipal securities at www.sec.gov/info/municipal/mbonds/omstoc.shtml.

Executive Summary—Regulatory, Legislative, and Other Developments

- The OMB has issued its March 2001 Supplement and also recently issued a revised data collection form to report the results of Circular A-133 audits for audit periods ending on or after January 1, 2001.
- Many federal OIGs and state-level agencies with oversight responsibilities for Circular A-133 audits are increasing their scrutiny of completed audits through desk reviews, quality control reviews, and other types of examinations.
- The AICPA recently issued a new edition of its nonauthoritative Circular A-133 Practice Aid. We have updated the AICPA's unofficial frequently asked questions regarding Circular A-133 for an inquiry received frequently in the past year relating to audit follow-up.
- The OMB amended Circular A-21 to require that many colleges and universities submit their F&A rate proposals in a standard format on or after July 1, 2001. In January 2001, the OMB issued a memorandum to address certain complex issues relating to Circular A-21.
- HUD requires PHAs and project owners of HUD-assisted housing to submit financial information electronically. REAC recently issued a document providing guidance on the detailed requirements for

electronic submission and the auditor's involvement in the process. There are changes in the requirements for electronic submission and re-submission after January 1, 2001. PHAs not subject to Circular A-133 because they expend less than \$300,000 of federal awards still are required to electronically submit unaudited data.

- The GAO is expected to soon issue an ED to amend the Yellow Book standards concerning the independence of individuals and organizations that conduct financial and performance audits. The GAO also is expected to issue an omnibus ED in 2001 to propose changes to various other areas of the Yellow Book.
 - The federal government and various state governments are enacting legislation to remove barriers to e-commerce by addressing the legality of electronic contracts and signatures.
 - In many cases, lump-sum settlements to employees are considered wages subject to FICA coverage.
 - The IRS issued final regulations to give guidance to employers that provide transportation fringe benefits to employees.
 - The IRS issued Revenue Rulings to specify the criteria that have to be met to automatically defer a certain percentage of an employee's compensation into a section 457 deferred compensation plan or a 403(b) plan.
 - The IRS has published information about the administration of section 457 deferred compensation plans. The IRS issued a Revenue Procedure to update and expand on its EPCRS.
 - The IRS has identified the "employee versus independent contractor classification" area as one with potentially significant compliance problems.
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Audit and Attestation Issues and Developments

Recent Auditing Standards

What are the AICPA's new auditing standards that affect state and local governments?

SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, and a Related Audit Guide

In September 2000, the Auditing Standards Board (ASB) issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1,

AU sec. 332), which supersedes SAS No. 81, *Auditing Investments*. SAS No. 92 is effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application is permitted.

SAS No. 92 provides guidance on planning and performing auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities, as defined in certain FASB standards. Among other things, SAS No. 92—

- Indicates that an auditor may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities, such as the ability to identify a derivative that is embedded in a contract or agreement.
- Presents examples of factors that affect inherent and control risk for assertions about derivatives and securities.
- Provides examples of audit procedures for derivatives, securities, and hedging activities.

SAS No. 92 applies to audits of governmental entities even though the definitions it uses to define its scope (AU sec. 332.) come from FASB standards.

In March 2001, the ASB issued an Audit Guide, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, to help practitioners implement SAS No. 92. The Guide includes an overview of derivatives and securities and the general accounting considerations for them, as well as case studies that address such topics as control risk considerations when service organizations provide securities services, inherent and control risk assessment, and designing substantive procedures based on risk assessments.

SAS No. 93, *Omnibus Statement on Auditing Standards—2000*

In October 2000, the ASB issued SAS No. 93, *Omnibus Statement on Auditing Standards—2000* (AICPA, *Professional Standards*, vol. 1, AU secs. 315, 508, and 622). The SAS—

- Withdraws SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec.

622). All agreed-upon procedures engagements will now be performed under the attestation standards. (See the discussion later in this section of the Audit Risk Alert entitled “Recent Attestation Standards.”) The withdrawal of SAS No. 75 is effective for agreed-upon procedures engagements for which the subject matter or assertion is as of or for a period ending on or after June 1, 2001.

- Amends SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), to include a reference in the auditor’s report to the United States of America as the country of origin of (1) the accounting principles used to prepare the financial statements and (2) the auditing standards the auditor followed in performing the audit. (See the related discussion in the section of this Audit Risk Alert entitled “Revised Auditor’s Reports.”) This amendment makes other related changes in the AICPA auditing literature, such as withdrawing Auditing Interpretation No. 13, “Reference to Country of Origin in the Auditor’s Standard Report,” of SAS No. 58. This amendment is effective for reports issued or reissued on or after June 30, 2001. Earlier application is permitted.
- Amends SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), to clarify the definition of a predecessor auditor to include any auditor who is engaged to perform, but does not complete, an audit. This amendment is effective for audits of financial statements for periods ending on or after June 30, 2001. Earlier application is permitted.

SAS No. 94, *The Effect of Information Technology on the Auditor’s Consideration of Internal Control in a Financial Statement Audit*

In May 2001, the ASB issued SAS No. 94, *The Effect of Information Technology on the Auditor’s Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 94 is an amendment to SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*. SAS No. 94

is effective for audits of financial statements for periods beginning on or after June 1, 2001. Earlier application is permitted.

SAS No. 94 amends previous guidance on the independent auditor's consideration of an entity's internal control in an audit of financial statements in accordance with GAAS. It indicates that, in obtaining an understanding of internal control sufficient to plan the audit, the auditor should consider how an entity's use of IT and manual procedures may affect controls relevant to the audit to assess control risk. SAS No. 94—

- Incorporates and expands the concept from SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326.14), that in circumstances where a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, and reported, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk.
- Describes how IT may affect internal control, evidential matter, and the auditor's understanding of internal control and assessment of control risk.
- Describes both the benefits and risks of IT to internal control, and how IT affects the components of internal control, particularly the control activities and information and communication components.
- Provides guidance to help auditors determine whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the controls, or to design and perform audit procedures.
- Clarifies that in obtaining an understanding of the entity's financial reporting process, the auditor should understand how

both standard, recurring entries and nonstandard, nonrecurring entries are initiated and recorded, and also should understand the controls that have been placed in operation to ensure that such entries are authorized, complete, and correctly recorded.

- Updates terminology and references to IT systems and controls.

SAS No. 94 does not eliminate the alternative of assessing control risk at the maximum level and performing a substantive audit, if that is an effective approach. However, it notes that when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form, an auditor's ability to obtain the desired assurance only from substantive tests would significantly diminish. SAS No. 94 also does not change the requirement to perform substantive tests for significant account balances and transaction classes.

Auditing Interpretations

In December 2000, the ASB issued four interpretations of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312):

1. Interpretation No. 1, "The Meaning of the Term Misstatement" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.01-.04)
2. Interpretation No. 2, "Evaluating Differences in Estimates" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.05-.09)
3. Interpretation No. 3, "Quantitative Measures of Materiality in Evaluating Audit Findings" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.10-.14)
4. Interpretation No. 4, "Considering the Qualitative Characteristics of Misstatements" of SAS No. 47, *Audit Risk and*

Materiality in Conducting an Audit (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.15-.17)

Those interpretations address—

- The meaning of the term *misstatement*, which is a condition that causes financial statements not to be in conformity with GAAP or with an other comprehensive basis of accounting (OCBOA).
- The auditor's evaluation of the difference between an estimate best supported by audit evidence and the estimate included in the financial statements.
- Factors to be considered in determining quantitative measures of materiality, for example, the results of continuing operations.
- Factors to be considered in determining the qualitative characteristics of misstatements, for example, the effect of misclassifications between operating and nonoperating income.

These Interpretations became effective upon issuance. You can find them on the AICPA Web site at www.aicpa.org/members/div/auditstd/announce/index.htm. The Interpretations also are included in the AICPA's *Professional Standards*, vol. 1, AU sec. 9312.

Recent Attestation Standards

What are the AICPA's new attestation standards that affect state and local governments?

The ASB issued SSAE No. 10, *Attestation Standards: Revision and Recodification*, in January 2001. SSAE No. 10 supersedes existing SSAE Nos. 1 through 9 and is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001. Early application is permitted.

The attestation standards enable practitioners to provide assurance on subject matter other than financial statements. One of the primary reasons why the ASB decided to revise the attestation standards

was to make them internally consistent and easier for practitioners to use in crafting and performing attest engagements. The following are examples of governmental engagements commonly performed under the attestation standards:

- “Limited scope audits” under Circular A-133 that pass-through entities use to monitor subrecipient compliance with certain requirements (Circular A-133 defines “limited-scope audits” as agreed-upon procedures engagements conducted in accordance with either the AICPA’s GAAS or attestation standards. After SSAE 10 is effective, those engagements will only be performed under the attestation standards.)
- An agreed-upon procedures engagement to compare the data that a public housing authority submits electronically to HUD to the hard copy of the audit report and financial data schedule (See the earlier section of this Audit Risk Alert entitled “HUD Electronic Submission Requirements for Public Housing Authorities.”)
- An agreed-upon procedures engagement to determine whether an activity’s net revenues are sufficient to meet a revenue bond’s revenue coverage covenant

Among other changes to the attestation standards, SSAE No. 10—

- Changes the title of AT section 100 from *Attestation Standards* to AT section 101, *Attest Engagements*.
- Changes the definition of an attest engagement to state that it applies to engagements in which a certified public accountant in the practice of public accounting (hereinafter referred to as a *practitioner*) is engaged to issue or does issue an examination; a review; or an agreed-upon procedures report on subject matter, or an assertion about the subject matter, that is the responsibility of another party.
- Revises the third general standard to focus on the essential elements of criteria. The criteria must be suitable and must be available to users. The subject matter also must be capable of evaluation against the criteria.

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- Enables true direct reporting on subject matter by eliminating the requirement to make reference to the assertion in the practitioner's report.
 - Provides expanded guidance on the circumstances in which the use of attest reports should be restricted to specified parties.

The new SSAE eliminates the requirement for the practitioner to obtain a written assertion in an agreed-upon procedures attest engagement. It also incorporates changes needed as a result of the withdrawal of SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*, from the auditing standards. (See the discussion about SAS No. 93 earlier in this section of the Audit Risk Alert at "Recent Auditing Standards.")

2001 Audit and Accounting Guide and SOP 98-3 Conforming Changes

What conforming changes have been made to the 2000 edition of the AICPA Audit and Accounting Guide Audits of State and Local Governmental Units and SOP 98-3?

We have updated the AICPA's 1994 Audit and Accounting Guide *Audits of State and Local Governmental Units* as well as SOP 98-3,⁵ which appears as an appendix to the Guide, for conforming changes as of May 1, 2001. We made revisions for the issuance of SAS No. 92 and No. 93 and SSAE No. 10 and added footnotes alerting auditors to the issuance of SAS No. 94. We also made minimal changes to the Guide to reflect the provisions of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, and No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*.

5. Some auditors have been unaware that SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, is updated annually for conforming changes, including changes resulting from last year's two Yellow Book amendments. Although the AICPA does not normally make conforming changes to SOPs, SOP 98-3 has been, and will continue to be, revised annually to keep it up-to-date for changes in the Yellow Book, single audit literature and processes, and Statements on Auditing Standards.

The Guide continues to explain how an AICPA task force is revising the Guide to incorporate the provisions of GASB Statements No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, and No. 35, *Basic Financial Statements—and Management’s Discussion and Analysis—for Public Colleges and Universities*, and GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*. (See the discussion about the Guide revision project in the section of this Audit Risk Alert entitled “Revision of State and Local Governmental Units Audit and Accounting Guide.”)

Help Desk—You can obtain a copy of the 2001 Guide by calling the AICPA Order Department at (888) 777-7077 and asking for Product No. 012062kk.

Revised Auditors’ Reports

Have the AICPA’s illustrative auditors’ reports changed because of SAS No. 93?

The AICPA has revised references to and examples of auditors’ reports in its *Professional Standards* to include an identification of the United States of America as the country of origin of the accounting principles used to prepare the financial statements and of the auditing standards the auditor followed in performing the audit, as required by SAS No. 93. (See the discussion of SAS No. 93 earlier in this section of this Audit Risk Alert at “Recent Auditing Standards.”) As a result, we made similar changes to the following illustrative auditors’ reports included in the Audit and Accounting Guide *Audits of State and Local Governmental Entities* as of May 1, 2001, and in SOP 98-3:

- Reports on the financial statements
- Reports on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*
- Reports on compliance with requirements applicable to each major program and on internal control over compliance in accordance with OMB Circular A-133

You should note that SAS No. 93 does not affect the reference in the auditor's report to *Government Auditing Standards*, issued by the Comptroller General of the United States, because that citation already indicates the country of origin of those standards.

Help Desk—The updated illustrative auditors' reports are available in the Audit and Accounting Guide *Audits of State and Local Governmental Entities* as of May 1, 2001, in SOP 98-3, and on the AICPA Web site at www.aicpa.org/belt/a133main.htm.

Revision of State and Local Governmental Units Audit and Accounting Guide

Does the AICPA have any tentative guidance about audit issues relating to financial statements prepared in conformity with GASB Statement No. 34?

An AICPA task force has been working for nearly two years on a comprehensive revision of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*. The revision will address the audits of basic financial statements and required supplementary information prepared in conformity with the new governmental financial reporting model required by GASB Statement No. 34 and associated standards.

Significant issues facing the task force include the auditor's responsibility for supplementary information in differing situations, audit procedures relating to infrastructure assets accounted for using the modified approach, and illustrative auditor's reports. Another major issue is the appropriate level at which to set materiality for audit planning and reporting purposes. The task force has been working on that materiality issue (see the following discussion) and continues to hope that a resolution of that issue in the near term will permit the AICPA to issue the revised Guide sometime early in 2002. At present, the task force does not intend to establish new "category B" GAAP⁶ relating to GASB Statement No. 34. Conse-

6. See the discussion of the hierarchy of generally accepted accounting principles (GAAP) for state and local governmental entities in SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 411).

quently, the AICPA is not required to, and does not presently plan to, expose the revised Guide for public comment.

The following subsections discuss some of the tentative results of the task force's deliberations *for your information only*. All the task force's decisions are currently tentative and, ultimately, will be subject to review and clearance by the ASB before becoming final.

Effective Date

The task force has tentatively decided that the revised Guide should be effective for audits of a state or local government's financial statements in the fiscal period in which the government is first required to apply the provisions of GASB Statement No. 34 or No. 35. Earlier application would be required for an audit of a government that early implements Statement No. 34 or No. 35 after the issuance of the revised Guide. The 1994 Guide (updated annually for conforming changes) would remain effective for audits of governments that have not yet implemented, and that are not yet required to implement, Statement No. 34 or No. 35.

Materiality

How should the revised Audit Guide establish audit planning and reporting materiality for the new financial reporting model? For the financial statements taken as a whole? By financial statement category (government-wide, governmental funds, proprietary funds, and fiduciary funds)? By financial statement column? In some other manner? These are the questions that the Audit Guide revision task force has been diligently considering, with advice and input from the ASB's Audit Issues Task Force and in consultation with the GASB. (See also the discussion later in this Audit Risk Alert about the GASB's new project on basic financial statements in the section entitled "GASB Pronouncements, Exposure Drafts, and Additional Projects.")

Until the materiality issue is resolved and the Audit Guide revision issued, the task force advises auditors that are dealing with entities that implement GASB Statement No. 34 to use professional judgment and consider the guidance in SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended, and the current Audit

Guide to apply materiality to financial statements prepared in conformity with GASB Statement No. 34. Paragraph 3.12 of the current Audit Guide states that audit scope should be set and materiality evaluations should be applied at the fund type, account group, and discretely presented component unit column(s) when reporting on the general purpose financial statements (GPFS), or at the individual fund statement level when reporting on the GPFS, combining and individual fund financial statements in a comprehensive annual financial report (CAFR).

Other Audit Issues Under GASB Statement No. 34

Departures from GAAP and OCBOA Financial Statements. The Audit Guide revision task force has received several inquiries from auditors about the effect on the auditor's report if a government does not fully comply with the provisions of GASB Statement No. 34. Those questions have focused on whether and how the auditor's report should be modified if, for example, a government presents—

- Only fund financial statements (focusing on major funds) following the GASB Statement No. 34 reporting model, but not government-wide financial statements.
- Only government-wide financial statements following the GASB Statement No. 34 reporting model, but not fund financial statements.
- Only combined financial statements by fund type, using the pre-GASB Statement No. 34 reporting model.
- Cash or modified cash basis financial statements, but without using the formats required by GASB Statement No. 34 for government-wide and fund financial statements.

Whether a government has fully complied with the provisions of GASB Statement No. 34 always is subject to a materiality determination. In its deliberations to date, the task force has strongly supported full implementation of GASB Statement No. 34, subject to materiality, for an auditor to issue an unqualified opinion that the financial statements are in conformity with GAAP. In addition, the task force tentatively believes that providing less than a full set of financial statements that complies with the provisions of GASB

Statement No. 34 normally should result in an adverse opinion on the government's financial statements.⁷ Further, the task force believes that if the government omits required infrastructure capital assets from the government-wide financial statements (considering the delayed effective dates for the retroactive capitalization of general infrastructure assets), the auditor should issue either a qualified or adverse opinion, depending on the materiality of the omission. Because for many governments infrastructure would be significant in relation to the government-wide financial statements, an adverse opinion usually would be appropriate.

With one exception, the task force tentatively believes that, under the provisions of SAS No. 62, *Special Reports*, neither the presentation of governmental financial statements using the pre-GASB Statement No. 34 reporting model nor a less-than-complete implementation of the new financial reporting model is an other comprehensive basis of accounting (OCBOA). The exception is if the presentation used by the reporting entity is required to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. Note, however, that SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), requires the auditor's report on such financial statements to include a separate paragraph at the end to indicate that it is a restricted-use report.

The task force tentatively believes that if a government issues an OCBOA report using the cash or modified cash basis of accounting, the auditor should evaluate whether the financial statement format and disclosures communicate the information required by GASB Statement No. 34's format and disclosure requirements. If that information is not communicated, the auditor should modify the opinion on those financial statements. Whether that modification would be a qualified, adverse, or disclaimer of opinion depends on the magnitude and pervasiveness of the omitted information.

7. The task force tentatively believes, however, that auditors should be able to continue to present an unqualified opinion on the financial statements of a fund and on a department that constitutes less than a fund. However, due to the unsettled nature of the materiality issue, the task force will be further considering its position on fund and department financial statements and how to best communicate that position to auditors.

However, the task force tentatively believes that the presumption would be to issue an adverse opinion.

This tentative conclusion is based on SAS No. 62, which requires that “. . . when the [OCBOA] financial statements contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate.” (See also Interpretation No. 14, “Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting,” of SAS No. 62 [AICPA, *Professional Standards*, vol. 1, AU sec. 9623.88–93.])

Auditor Independence. Ethics Interpretation No. 101-10, “The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements,” of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12) discusses, as its title implies, the effect on an auditor’s independence of relationships with entities included in governmental financial statements. However, that Interpretation has not been updated to consider the changes in financial statement presentation provided by GASB Statement No. 34. The task force tentatively believes that auditors of entities that implement GASB Statement No. 34 should use professional judgment, using the concepts expressed in Ethics Interpretation 101-10, to evaluate independence in relation to a primary government, parts of the primary government (such as governmental activities, business-type activities, major funds, and fund types), component units, and other organizations disclosed in the reporting entity’s financial statements until such time as the Interpretation is updated.

Management’s Discussion and Analysis (MD&A). GASB Statement No. 34, paragraph 11, specifies eight information areas that should be presented in a government’s MD&A, which is required supplementary information (RSI). A government may want to include in MD&A information other than that prescribed in GASB Statement No. 34. However, the GASB staff’s *Guide to Implementation of GASB Statement 34 on Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments* (GASB 34 Q&A), item 10, explains that governments are

not permitted to discuss in MD&A issues other than those included in the requirements of GASB Statement No. 34 and provides examples of MD&A discussions that go beyond the requirements. (The GASB staff implementation guide is discussed in the section of this Audit Risk Alert entitled “GASB Statement No. 34 Implementation Guidance.” See also the discussion in the section of this Audit Risk Alert entitled “GASB Pronouncements, Exposure Drafts, and Additional Projects” about the exposure draft of a proposed Statement that would clarify the provisions of GASB Statement No. 34 concerning MD&A.)

SAS No. 52, *Omnibus Statement on Auditing Standards—1987* (AICPA, *Professional Standards*, vol. 1, AU sec. 558, “Required Supplementary Information”), requires the auditor to apply certain limited procedures to RSI and to report deficiencies in, or the omission of, such information. Among the deficiencies defined by SAS No. 52 is presentation of RSI that departs materially from prescribed guidelines. The task force tentatively believes that if a government you audit includes information in MD&A that is not required, that constitutes the presentation of RSI that departs materially from prescribed guidelines. You should consider discussing with management the need to remove that information from the MD&A. The government could, for example, relocate that information to the report’s transmittal letter or to a supplementary schedule. If management decides to retain the information in the MD&A, the task force tentatively believes you should add an explanatory paragraph to your report on the audited financial statements to describe the deficiency in the RSI. SAS No. 52 (AU sec. 558.08) provides an example of that explanatory paragraph.

RSI is not a required part of the entity’s basic financial statements. Therefore, even though deficiencies in, or the omission of, RSI will result in the inclusion of an explanatory paragraph in the auditor’s report, they do not affect the auditor’s opinion on the fairness of presentation of the financial statements in conformity with GAAP.

Recording and Depreciating Capital Assets. GASB Statement No. 34 requires a government to report in its financial statements all capital assets, including infrastructure capital assets, except that certain capital assets need not be capitalized (such as certain collections of

works of art and certain general infrastructure assets owned before GASB 34 is implemented). The Statement also requires that many of the reported capital assets be depreciated. Most governments have not been reporting general infrastructure assets (which are infrastructure assets associated with governmental activities) in their financial statements, and many currently may not have information that will support capitalizing and depreciating those assets. Some governments also currently may not have the information they need to calculate depreciation on their non-infrastructure capital assets (such as salvage values or estimated useful lives) or to classify depreciation by function.

Therefore, many governments may need to develop or expand accounting records relating to capital assets to comply with GASB Statement No. 34. In general, governments and their auditors expect this to be a considerable task. Therefore, if the governments you audit have not yet started this process, you may want to suggest that they do so. Further, you may want to work with them as they plan and implement that process to help to ensure that the resulting information will provide sufficient, competent evidential matter when that information becomes subject to audit.

The Modified Approach for Reporting Infrastructure. GASB Statement No. 34 permits governments not to depreciate infrastructure assets that are networks or subsystems of networks (eligible infrastructure assets), an alternative termed *the modified approach*, as long as two requirements are met. First, the government has to manage the eligible infrastructure assets using an asset management system that has certain characteristics. Second, the government has to document that the eligible infrastructure assets are being preserved approximately at (or above) a condition level established and disclosed by the government. GASB Statement No. 34, paragraphs 23 and 24, provides details about the required characteristics of the asset management system and the required documentation of the condition of the assets. If a government you audit uses the modified approach, your audit procedures will likely include evaluating whether the asset management system and the documentation of the condition of the assets comply with the standards in GASB Statement No. 34. The following discusses some of the task force's

tentative observations on an auditor's consideration of a government's use of the modified approach.

To use the modified approach, GASB Statement No. 34, paragraph 24, requires the government to document that the three most recent complete condition assessments provide reasonable assurance that the eligible infrastructure assets are being preserved approximately at (or above) the condition level established and disclosed by the government. (GASB Statement No. 34 permits governments to begin to use the modified approach with only one complete condition assessment.) The task force tentatively believes that there are two interrelated matters involved in evaluating whether a government has met that requirement. One has to do with whether and to what extent each of the three condition assessments could be below the established condition level (see the following paragraph). The other has to do with whether a single substandard condition assessment constitutes a breach of the requirement (see the second following paragraph).

The standard's use of the term *approximately* allows flexibility. The actual condition levels do not have to equal or exceed the condition level established by the government; a reasonable variance below the established level is permissible. The task force tentatively believes that the auditor could view "reasonableness" in this context from several perspectives and is working on examples for the Audit Guide revision. One potential example concerns the percentage variance between the actual and established condition levels. For example, an actual level of 72 would vary from an established level of 75 by 4 percent (that is, 72 is 96 percent of 75). In that situation, the government and the auditor might judge the 4 percent variance to be reasonable for purposes of determining whether the infrastructure assets are being preserved approximately at the condition level established by the government.

GASB Statement No. 34 does not specify that a single substandard condition assessment constitutes a breach of the requirement. If that had been the intent, the use of the modified approach would have been conditioned on *each* complete condition assessment providing reasonable assurance that the eligible infrastructure assets are being preserved approximately at (or above) the established condi-

tion level. The requirement to consider the results of the *three* most recent condition assessments requires the preparer and auditor to take a broader perspective to the evaluation and consider the three condition assessments together as a whole. The task force tentatively believes that one approach would be to consider the trend of the three most recent condition assessments; an upward trend would be more “reasonable” than a downward trend. However, the nature and circumstances surrounding a single substandard condition assessment might lead to a conclusion that the three most recent condition assessments, taken as a whole, do not provide the stipulated reasonable assurance. The task force tentatively believes that the auditor should exercise professional judgment to determine whether a single substandard condition assessment taken together with the two other assessments provides reasonable assurance that the eligible infrastructure assets are being preserved approximately at (or above) the established condition level.

The task force has tentatively concluded that an auditor cannot evaluate the results of a condition assessment until it is complete, which GASB Statement No. 34 permits to take up to three years. GASB Statement No. 34 also does not require that condition assessment activities be conducted every year; it requires that a complete condition assessment be conducted only at least every three years. Therefore, an entity may disclose in its summary of significant accounting policies that it uses the modified approach to account for eligible infrastructure assets even though there has been no condition assessment activity during the period. When this occurs, the auditor should consider obtaining a specific representation of the entity’s intent to use the modified approach in the management representation letter. To substantiate that intent, the auditor could, for example, review minutes of governing board meetings, compare the year’s actual maintenance/preservation costs to the estimated amount, and discuss the plans for future condition assessment activity with the staff that perform the assessments. What happens if the entity does not represent that it intends to continue to use the modified approach, for example, if it represents that it intends to change to the depreciation method before the next complete condition assessment is required? The task force tentatively believes that the auditor should consider whether that intention affects the carrying

value of the assets, is adequately disclosed in the financial statements, and affects the auditor's opinion on the financial statements.

GASB Statement No. 34 requires condition assessments to be documented in such a manner that they can be replicated. The task force tentatively believes that determining whether a condition assessment is replicable does not require the auditor to re-perform all or part of the condition assessment, although such a procedure could be used. Instead, the auditor could consider items such as the following in evaluating whether condition assessments are replicable:

- Internal control over the input and output of information
- The extent to which the procedures needed to use the method are documented
- The nature and level of training provided to those who perform the condition assessments to ensure consistent application of the measurement method
- The extent to which the method addresses obvious variables in the condition of the assets it evaluates (For example, if a condition assessment method for highways does not in some fashion consider the condition of road surfaces, it might be considered to be a less-than-complete method.)

If a condition assessment is found not to be replicable and the entity continues to apply the modified approach in the subsequent reporting period, that constitutes a departure from GAAP, not a scope limitation.

The task force also tentatively believes that the auditor should consider evaluating whether complete condition assessments have been performed in a consistent manner, as required by GASB Statement No. 34, paragraph 24. The GASB 34 Q&A, item 255, states that consistency is achieved if the entire condition assessment is performed using the same condition assessment method, basis for the condition measurement, and measurement scale. A government may change the method, basis, or scale before beginning the subsequent complete assessment. For example, if a government performs its condition assessment over a three-year cycle, and changes the method, basis, or scale during the third year of the cycle, it would

have to perform a condition assessment on all (or a statistical sample) of the subject assets during that third year using the new method, basis, or scale. Alternatively, the government could complete the cyclical condition assessment using the old method, basis, or scale, and make the change at the beginning of the next assessment cycle. If changes are made in the method, basis, or scale used during the periods covered by the RSI schedules that are required when using the modified approach, the auditor should consider determining whether those changes are appropriately disclosed as required by GASB Statement No. 34, paragraph 133.

Effect of New Accounting Standards on Current-Period Financial Statements and Auditors' Reports

Do governments have to disclose currently that their accounting will change in the future as a result of new standards that are not yet effective?

Recent GASB standards may make it necessary for governments to make additional disclosures this year, even though they are not yet required to implement the standards and have not elected to adopt those standards early.

Interpretation No. 3, "The Impact on an Auditor's Report of an FASB Statement Prior to the Statement's Effective Date," of SAS No. 1, *Adherence to Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 9410.13–18), discusses the effect on the financial statements and the auditor's report if the future application of an issued standard will require the future restatement of the financial statements because of the retroactive application of the new standard by prior period adjustment. Although the Interpretation is written in terms of FASB standards, it is equally applicable to GASB standards.

The Interpretation says that an auditor should not qualify his or her opinion if an entity does not adopt an FASB standard early. However, for financial statements that are prepared in conformity with GAAP that are acceptable at the financial-statement date but that will not be acceptable in the future, auditors should consider whether disclosure of the impending change in principle and the resulting restatement are data that are essential for a fair presenta-

tion in conformity with GAAP. If you decide that the matter should be disclosed and it is not, you should express a qualified or adverse opinion on conformity with GAAP, as required by SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.41).

The Interpretation gives you guidance to evaluate whether prospective changes in GAAP, such as those associated with GASB Statement No. 34 and GASB Interpretation No. 6, are adequately disclosed. The Interpretation says that even if the auditor decides that the disclosure of the forthcoming change and its effects are adequate and, consequently, decides not to qualify the opinion, he or she nevertheless may decide to include an explanatory paragraph in the report if the effects of the change are expected to be unusually material.

Common Engagement Deficiencies

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What are some of the common deficiencies cited in governmental audit engagements?
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Following are some deficiencies commonly noted on governmental engagements during recent peer reviews and AICPA Professional Ethics Division investigations of CPA firms. This list continues to include the deficiencies identified in last year's Audit Risk Alert, indicating continuing problems with the same matters. You should consider reviewing your firm's policies and procedures to see whether your governmental engagements also might have these kinds of issues.

- Major programs are not properly identified because not all of the elements of the risk-based approach are used (see Circular A-133, section .520).
- The required *Government Auditing Standards* reports for internal control or compliance are not prepared or are not referred to in the report on the financial statements.
- The appropriate Circular A-133 reports are not included.
- The required compliance testing is not performed or documented.

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- Internal control and compliance tests, including sampling applications, are not adequately designed to support the reports issued.
 - The various additional *Government Auditing Standards* requirements for working paper documentation (such as those in *Government Auditing Standards*, paragraphs 4.21.3 and 4.35) are not followed.
 - The management representation letter is not appropriately tailored for an audit in accordance with Circular A-133, as required by SAS No. 85, as amended by SAS No. 89; and SOP 98-3, paragraph 6.69.
 - The auditor used inadequate or outdated reference material related to the engagement performed.
 - *Government Auditing Standards*' continuing professional education requirements are not met.
 - The auditor has not appropriately followed federal agency audit guides.
 - Particular funds are not correctly accounted for.
 - The auditor has not used the AICPA's standards for attestation engagements when applicable in a compliance audit engagement.

See also the section of this Audit Risk Alert entitled "Circular A-133 Audit Reviews" for additional information about common audit deficiencies.

Governmental Employee Benefit Plans

Does the Audit Risk Alert on employee benefit plans cover governmental entities?

Until this year, the Audit Risk Alert, *Employee Benefit Plans Industry Developments*, has not addressed PERS or other governmental employee benefit plans. That is because that Alert is a complement to the AICPA Audit and Accounting Guide *Audit of Employee Benefit Plans*, which does not apply to governmental entities. Starting this

year, that Alert has added a section to address audit, accounting, and regulatory issues unique to PERS and other governmental employee benefit plans.⁸ We've included here an adaptation of Appendix D of the *Employee Benefit Plans Industry Developments* Alert that provides some information that auditors may need to know about governmental employee benefit plans.

Help Desk—The section entitled “References for Additional Guidance” at the end of this Audit Risk Alert lists certain GFOA publications that address topics such as the administration of and financial reporting for PERS. In addition, please refer to the section entitled “Internal Revenue Service Activities,” for discussion of regulatory issues that may affect PERS and other government employee benefit plans.

“Government Employee Benefit Plans,” an adaptation from the *Employee Benefit Plans* Audit Risk Alert—2001 (appendix D)

The accounting for certain governmental employee benefit plans is prescribed by GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*,⁹ and No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*.¹⁰

Governmental plans encompass retirement systems offered by state and general-purpose local governments also known as PERSs, as well as single employer plans offered by special-purpose governmental entities, such as hospitals. Governmental benefit plans are not subject to the Employee Retirement Income Security Act (ERISA) and are not required to file annual financial and other information with the IRS and the Department of Labor (DOL). However,

8. In addition to the guidance provided here, the AICPA Employee Benefit Plans Expert Panel has established a task force to focus on issues relating to government employee benefit plans.

9. GASB Statement No. 25 establishes financial reporting standards for defined benefit pension plans and for the notes to the financial statements of defined contribution plans of state and local governmental entities.

10. GASB Statement No. 26 establishes financial reporting standards for postemployment healthcare plans administered by state and local governmental defined benefit pension plans. It is an interim statement pending completion of the GASB's project on accounting and financial reporting of other postemployment benefits by plans and employers.

GASB standards requires certain plans to include certain supplementary information with their annual financial statements, and some plans typically include other supplementary information and schedules. In addition, some states may establish additional reporting requirements on local government and special-purpose government plans.

There are over 2000 PERs in the United States with more than \$1.9 trillion dollars in cash and security holdings. Many of these PERs voluntarily seek to receive an annual certification to denote quality in financial reporting for governmental entities.

Current Trends. A recent survey¹¹ of governmental plans gathered key aspects of state and local retirement system's administration, retirement benefits, actuarial methods and assumptions, actuarial liabilities and assets, contributions, investments, and rates of investment return. The survey results found that PERs generally are well funded. (These results were briefly discussed in the earlier section of this Audit Risk Alert entitled "The State of the Economy.") Other current trends show a shift of pension assets to equities from bonds, a reduction in employer contribution requirements, a slight increase in base benefits, and an increase in number and size of cost-of-living adjustments (COLAs). The survey, in part, showed that, in the aggregate—

- The funding level improved from 82 percent to 95.2 percent.
- Five-year portfolio returns increased from 10.62 percent in 1992 to 13.36 percent in 1998, while investment assumptions rose from 7.83 percent in 1992 to 7.88 percent in 1998.
- The portion of assets held in domestic equities rose from 39.3 percent in 1992 to 47.9 percent in 1998. The portion of assets held in international equities rose from 3.7 percent in 1992 to 12.0 percent in 1998.
- The percentage of plans with COLAs increased from 57 percent in 1992 to 77 percent in 1998.

11. Survey was prepared for the members of the Public Pension Coordinating Council (PPCC) by the Government Finance Officers Association Research Center.

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- The average employer contribution rate as a percentage of covered salary fell from 13.19 percent in 1992 to 11.62 percent in 1998.

Other trends for government pension plans include the following:

- Many pension plans are beginning to invest in new areas in an attempt to obtain higher returns. Accordingly, many pension plans are investing in new types of investments.
- Many pension plans are now paying performance-based bonuses to investment managers.
- Pension plans are moving into higher risk investments (also called innovative, sophisticated risk strategies). These investment strategies include high-yield (junk) bonds, private equity, venture capital, and hedge funds, for example.
- Many pension plans are outsourcing more investment management functions, especially in newer areas that may include investments of higher risk. In many cases, the entire process of investing, processing transactions, and accounting for these investments is outsourced, and the manager is effectively a third-party administrator.
- Plans are making more use of soft dollars in order to obtain use of funds that may be outside of the budget and normal controls, or not on the general ledger.
- Plans are making increased use of securities' lending programs, primarily in response to the preferred practices of the plans' trustee-custodian institutions. The plan often receives additional income as a result of this practice.
- Plans are adding a deferred retirement option program (DROP). The person "retires," but continues to work for a defined amount of time while the retirement payments are accumulated in a deferred payment account. The deferred payment money is generally distributed in a lump sum to the person at the time of "true retirement" at the end of the defined time.

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- PERSs are becoming more autonomous from the sponsoring government to the extent that many are choosing to employ separate independent accountants.

Independence Implications. PERSs issue separate financial statements that often are included in a primary government's financial statements. If the PERS's auditors are different from those of the primary government (provided the PERS's financial statements are material to the primary government), the PERS's auditors need to be independent of the primary government in order for the primary government's auditors to rely on the work of the other auditors. Depending on the timing of the respective audits, postreport review procedures may be required by the PERS's auditors for inclusion of their financial statements in the sponsoring organization's financial statements. (For additional discussion of independence issues see the "Auditor Independence" section under the "Revision of State and Local Governmental Units Audit and Accounting Guide" section of this Alert).

Benefit Payment Risk. The accuracy of benefit payment calculations is a primary risk area due to the unique and complex definitions of compensation and years of service for PERSs. In fact, currently, some PERSs are involved in litigation regarding retroactive adjustment of benefits due to a change in the components of compensation. The determination of a participant's years of service becomes complex due to carryover years of service from other government agencies as well as credit for time served in the armed forces and other organizations. The latter credit is often "earned" as participants make additional contributions.

Investment Risk. In July 2000, the Association of Public Pension Fund Auditors (APPFA) issued the publication, *Statements of Key Investment Risks and Common Practices to Address those Risks*. This publication provides general guidance for pension plans and auditors of those plans in addressing investment risks. The document identifies key investment risks associated with public pension systems and common practices to address, manage, and, to the extent possible, control those risks.

Help Desk—A copy of the report is available free of charge to APPFA members on APPFA's Web site at www.appfa.org.

Service Organizations

How does the use of service organizations affect the audits of governmental entities?

Many governments use service organizations in a variety of ways. For example, governments use service organizations to process payroll or other accounting transactions; hold and invest assets for debt service, endowment, or construction purposes; process or pay claims for risk-financing activities or pension benefits; and process or collect property or other taxes or utility billings. Sometimes services organizations may be other governments. For example, a county may collect property taxes for cities, towns, villages, and school districts within the county and a state may collect income and sales taxes for other governments within the state.

In some instances, auditors have failed to address the requirements of SAS No. 70, *Service Organizations*, as amended by SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), concerning internal control at service organizations or have failed to address the electronic evidence aspects inherent in many of those circumstances. As a result, the auditor has inappropriately placed reliance on the internal control of service organizations in a number of instances, even failing to note in his or her working papers and auditor's reports the fact of material weaknesses at the service organizations that should have affected the audits of the user organizations.

Issued in December 1999 and effective upon issuance, SAS No. 88 updated the language and concepts in SAS No. 70 to provide a clearer definition of service organizations to which the standard applies. SAS No. 70, as amended, now states that it is applicable if an entity obtains services from another organization that are part of the entity's information system. SAS No. 88 also—

- Provided guidance to help auditors determine the types of services that would be considered part of an entity's information system.

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- Revised and clarified the factors a user auditor should consider in determining the significance of a service organization's controls to a user organization's controls.
 - Clarified the guidance on determining whether information about a service organization's controls is necessary to plan the audit.
 - Clarified that information about a service organization's controls may be obtained from a variety of sources.

You should consider reviewing SAS No. 70, as amended, and reevaluate the manner in which you address internal control (including the electronic evidence aspects of internal control) at service organizations in your audits of governmental entities.

Executive Summary—Audit and Attestation Issues and Developments

- The ASB has issued SAS No. 92, No. 93, and No. 94 as well as an audit guide to help practitioners implement SAS No. 92. The ASB also has issued four interpretations of SAS No. 47.
- The ASB issued SSAE No. 10 to revise and recodify the attestation standards.
- We have updated the AICPA's 1994 Audit and Accounting Guide *Audits of State and Local Governmental Units* as well as SOP 98-3, which appears as an appendix to the Guide, for conforming changes as of May 1, 2001.
- An AICPA task force is working on a comprehensive revision of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* because of the new governmental financial reporting model required by GASB Statement No. 34 and associated standards. This Audit Risk Alert discusses some of the tentative results of the task force's deliberations.
- Recent GASB standards may make it necessary for governments to make additional disclosures this year, even though they are not yet required to implement the standards and have not elected to adopt those standards early.
- We have listed some deficiencies commonly noted on governmental engagements during recent peer reviews and AICPA Professional Ethics Division investigations of CPA firms.

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- We've included an adaptation of Appendix D of the Employee Benefit Plans Alert that provides some information that auditors may need to know about governmental employee benefit plans.
 - Auditors of governmental entities sometimes have failed to address the requirements of SAS No. 70, as amended, concerning internal control at service organizations or have failed to address the electronic evidence aspects inherent in many of those circumstances.
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Accounting Issues and Developments

GASB Pronouncements, Exposure Drafts, and Additional Projects

The GASB has issued several new governmental accounting and financial reporting standards in the past several years. Most of those standards are not effective until periods ending after 2001; however, the GASB encourages governments to apply them earlier. You should determine which standards the governments you audit have elected to apply early.

GASB Pronouncements Effective During 2001

What GASB pronouncements generally become effective this year?

GASB Statement No. 33. GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, was issued in December 1998 to establish accounting and financial reporting standards for nonexchange transactions involving financial or capital resources (for example, most taxes, grants, and private donations). In a nonexchange transaction, a government gives (or receives) value without directly receiving (or giving) equal value in return. The principal issue addressed in that Statement is the timing of recognition of nonexchange transactions.

GASB Statement No. 33 identifies four classes of nonexchange transactions based on their principal characteristics that affect the timing of recognition:

- *Derived tax revenues*, which result from assessments imposed on exchange transactions (for example, income taxes, sales taxes, and other assessments on earnings or consumption)

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- *Imposed nonexchange revenues*, which result from assessments imposed on nongovernmental entities, including individuals, other than assessments on exchange transactions (for example, property taxes and fines)
 - *Government-mandated nonexchange transactions*, which occur when a government at one level provides resources to a government at another level and requires the recipient to use the resources for a specific purpose (for example, federal programs that state or local governments are mandated to perform)
 - *Voluntary nonexchange transactions*, which result from legislative or contractual agreements, other than exchanges, entered into willingly by the parties to the agreement (for example, certain grants and private donations)

GASB Statement No. 33 also distinguishes between two kinds of requirements on the use of resources: time requirements and purpose restrictions. Time requirements affect the timing of recognition of nonexchange transactions; purpose restrictions affect the classification of net assets, equity, or fund balances, as appropriate, but do not affect when a nonexchange transaction is recognized.

The timing of recognition for each class of nonexchange transaction is as discussed in the following list. For revenue recognition, the standard for accrual-basis recognition is indicated, followed by the standard for modified accrual-basis recognition.

- Derived tax revenues timing is as follows.
 - Assets should be recognized when the underlying exchange transaction occurs or resources are received, whichever is first.
 - Revenues should be recognized when the underlying exchange transaction occurs. (When modified accrual accounting is used, the resources also should be available.) Resources received before the underlying exchange has occurred should be reported as deferred revenues (liabilities).
- Imposed nonexchange revenues timing is as follows.
 - Assets should be recognized when the government has an enforceable legal claim to the resources or resources are re-

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- ceived, whichever is first. (For some governments, the enforceable legal claim for property taxes does not arise until the period after the period for which the taxes are levied. Those governments should recognize property taxes receivable in the same period that revenues are recognized.)
- Revenues should be recognized in the period when use of the resources is required or first permitted by time requirements (for example, for property taxes, the period for which they are levied), or at the same time as the assets if the government has not established time requirements. Resources received or recognized as receivable before the time requirements are met should be reported as deferred revenues. (When modified accrual accounting is used, the resources also should be available. For property taxes on the modified accrual basis, governments should apply NCGA Interpretation 3, *Revenue Recognition—Property Taxes*, as amended by GASB Interpretation No. 5, *Property Tax Revenue Recognition in Governmental Funds*, as discussed later in this section.)
 - Government-mandated and voluntary nonexchange transactions timing is as follows.
 - Assets (recipients) and liabilities (providers) should be recognized when all applicable eligibility requirements are met or (for asset recognition) resources are received, whichever is first. Eligibility requirements are established by the provider and may stipulate the qualifying characteristics of recipients, time requirements, allowable costs, and other contingencies.
 - Revenues (recipients) and expenses/expenditures (providers) should be recognized when all applicable eligibility requirements are met. (When modified accrual accounting is used, the resources also should be available.¹²) For

12. One often overlooked consequence of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, is that the modified accrual-based revenue from expenditure-driven grants is no longer recognized based on the recognition of the qualifying expenditures. Therefore, there may be a mismatch in periods between when governmental fund expenditures and revenue are recognized.

transactions in which the provider requires the recipient to use (sell, disburse, or consume) the resources in or beginning in the following period, resources provided before that period should be recognized as advances (providers) and deferred revenues (recipients). For transactions, such as permanent or term endowments, in which the provider requires that resources should be maintained intact in perpetuity, for a specified number of years, or until a specific event has occurred, resources should be recognized as revenues when received and as expenses/expenditures when paid.

GASB Statement No. 33 also provides guidance on recognizing promises made by private donors (pledges), contraventions of provider requirements, and nonexchange revenues administered or collected by another government. It requires accrual-based nonexchange revenues to be recognized net of estimated refunds and estimated uncollectible amounts. The Statement has an appendix with various nonauthoritative examples of the application of its standards.

GASB Statement No. 33 is effective for financial statements for periods beginning after June 15, 2000, with earlier application encouraged. However, the provisions of the Statement for accrual-basis revenue recognition for governmental activities cannot become effective until GASB Statement No. 34 (as discussed later in this section) becomes effective. Until GASB Statement No. 34 becomes effective, the modified accrual provisions of GASB Statement No. 33 should be used for governmental funds and expendable trust funds, and the accrual provisions should be used for proprietary funds; nonexpendable, pension, and investment trust funds; colleges and universities that use the AICPA College Guide model; and entities that use proprietary fund accounting. If a government elected early implementation of GASB Statement No. 34 for periods beginning before June 15, 2000, it also was required to early implement GASB Statement No. 33 at the same time.

The implementation of GASB Statement No. 33, as amended by GASB Statement No. 36 (as discussed next), will likely involve

additional audit effort in the year a government first implements the new standards. Governments may have established new accounting policies and internal control procedures to identify and classify their nonexchange transactions and to comply with the new recognition and financial reporting requirements. Further, the auditor will need to consider evaluating the prior-period adjustment and changes in opening balances that result from the transition provisions of the Statement.

GASB Statement No. 36. GASB Statement No. 36, *Recipient Reporting for Certain Shared Nonexchange Revenues*, was issued in April 2000 and its effective date coincides with a government's implementation of GASB Statement No. 33.

Under the general provisions of GASB Statement No. 33, when one government shares its revenues with another government, both the provider and the recipient governments account for the transaction as a voluntary or government-mandated nonexchange transaction, as appropriate. However, paragraph 28 of GASB Statement No. 33 created an exception to those general provisions. In certain situations (such as the sharing of sales and property taxes), it required recipient governments to account for the sharing as a derived tax or imposed nonexchange transaction. Consequently, recognition of the sharing could have differed between the provider government and the recipient government.

GASB Statement No. 36 provides symmetrical accounting treatment for those shared revenues by removing the exception from paragraph 28 of GASB Statement No. 33. Thus, recipients of shared derived tax or imposed nonexchange revenues should account for the sharing in the same manner as the provider government—as a voluntary or government-mandated nonexchange transaction, as appropriate. In addition, GASB Statement No. 36 allows governments to use any reasonable estimate to accrue revenue from those transactions. As originally written, paragraph 28 limited estimation methods.

GASB Interpretation No. 5. GASB Interpretation No. 5, *Property Tax Revenue Recognition in Governmental Funds*, is effective for financial statements for periods beginning after June 15, 2000, with

early application encouraged. This Interpretation amends NCGA Interpretation 3, *Revenue Recognition—Property Taxes*, by modifying the definition of *available* as the term relates to modified accrual-based property tax revenue recognition. The effect of this amendment is to remove the “due” consideration from the definition of *available* established in NCGA Interpretation 3. The revised definition of *available* is as follows: “*Available* means collected within the current period or expected to be collected soon enough thereafter to be used to pay liabilities of the current period.” You should note, however, that this Interpretation does not change the requirement that, for revenue recognition, the collection period after year end should not exceed sixty days.

GASB Pronouncements Effective After 2001, With Early Application Encouraged

What other GASB pronouncements have been issued recently that you should know about?

GASB Statement No. 34. When the GASB issued Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, in June 1999, the GASB chairman referred to it as “the most significant change to occur in the history of governmental financial reporting.” Given the significance of GASB Statement No. 34, you should consider starting to work with the governments you audit to prepare for implementation, which may in some cases take considerable effort. GASB Statement No. 34 includes nonauthoritative illustrations of the basic financial statements and supplementary information it requires. See also the sections of this Audit Risk Alert entitled “Revision of State and Local Governmental Units Audit and Accounting Guide,” “GASB Statement No. 34 Implementation Guidance,” and “GASB Statement No. 34 User Guides,” as well as the discussion in the next section of GASB exposure drafts outstanding.

The effective date to implement the requirements of GASB Statement No. 34 is based on the total annual revenues of a government’s governmental and enterprise funds (excluding other financing sources

and extraordinary items),¹³ measured in the first fiscal year ending after June 15, 1999, as follows. Earlier application is encouraged.

<i>Phase</i>	<i>Total Annual Revenues in the First Fiscal Year Ending After June 15, 1999 (in millions)</i>	<i>Implementation Required for Periods Beginning After June 15, —</i>
1	\$100 or more	2001
2	\$10 to \$100	2002
3	Less than \$10	2003

Each component unit is required to implement the Statement no later than the same year as its primary government, even if that is earlier than its “assigned” phase based on the component unit’s revenues in the first fiscal year ending after June 15, 1999. If a primary government chooses to implement GASB Statement No 34 earlier than required, all of its component units also are required to implement the Statement early.

GASB Statement No. 34 has special transition provisions relating to the reporting of general infrastructure assets (infrastructure assets associated with governmental activities). GASB Statement No. 34 requires prospective reporting of general infrastructure assets based on a government’s implementation phase. Retroactive reporting of all *major* general governmental infrastructure assets (which is a numerical measure based on the government’s reported general capital assets in the first fiscal year ending after June 15, 1999) is encouraged at the government’s “assigned” implementation date. However, phase 1 and 2 governments are given an additional four years after that date to report major general infrastructure assets retroactively—and they may limit that reporting to such assets acquired, significantly reconstructed, or significantly improved in fiscal years ending after June 30, 1980. Phase 3 governments are encouraged to report infrastructure retroactively, but may elect to

13. Certain entities should use measures other than total annual revenues to determine the appropriate implementation phase. For example, special-purpose governments engaged only in fiduciary activities should use total annual additions, rather than revenues

report general infrastructure prospectively only. GASB Statement No. 34's special infrastructure transition provisions do not apply to proprietary funds or special-purpose governments engaged only in business-type activities because their infrastructure assets already should have been capitalized.

GASB Statement No. 34 initially applied to all state and local governments except public colleges and universities. However, as explained later in this section, GASB Statement No. 35 extended the applicability of GASB Statement No. 34 to public colleges and universities.

Contents of General-Purpose External Financial Statements. GASB Statement No. 34 requires the general-purpose external financial statements for general-purpose governments to consist of—

- Management's discussion and analysis (MD&A), which is designated as required supplementary information (RSI).
- Basic financial statements, which include government-wide financial statements, fund financial statements, and notes to the financial statements.
- RSI other than MD&A.

The contents of general-purpose external financial statements for special-purpose governments that are engaged in only governmental activities (such as some library districts) or that are engaged in both governmental and business-type activities (such as some school districts) generally should be the same as for general-purpose governments. Special-purpose governments engaged only in business-type activities (such as utilities) should present only the financial statements required for enterprise funds, accompanied by MD&A and other RSI. Special-purpose governments engaged only in fiduciary activities (such as public employee retirement systems) should present only the financial statements required for fiduciary funds, accompanied by MD&A and other RSI.

MD&A. MD&A should be presented before the basic financial statements, introduce the basic financial statements, and provide an analytical overview of the government's financial activities. It should provide an objective and easily readable analysis of the gov-

ernment's financial activities based on currently known facts, decisions, or conditions. Among the requirements, MD&A should—

- Include comparisons of the current year to the prior year based on the government-wide information. However, in the first year that GASB Statement No. 34 is applied, governments are not required to restate the prior year information to provide the comparative data for MD&A.
- Provide an analysis of the government's overall financial position and results of operations to help users to assess whether that financial position has improved or deteriorated as a result of the year's activities.
- Provide an analysis of significant changes in the results and balances reported for major funds and an analysis of significant budget variances.
- Describe capital asset and long-term debt activity during the year.
- Describe currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations.

Basic Financial Statements. The basic financial statements replace a government's current general-purpose financial statements (GPFS). The basic financial statements consist of the government-wide financial statements, fund financial statements, and notes to the financial statements. (As noted earlier, certain special-purpose governments are not required to present the government-wide financial statements.)

Government-wide Financial Statements. The government-wide financial statements consist of two statements—a statement of net assets and a statement of activities. Those statements should be prepared using the economic resources measurement focus and the accrual basis of accounting and should report all of the assets, liabilities, revenues, expenses, and gains and losses of the government. However, because their resources are not available to finance the government's programs, fiduciary activities should be excluded from the government-wide statements. Each statement should distinguish between the governmental and business-type activities of the pri-

mary government and between the total primary government and its discretely presented component units by reporting each in separate columns or rows.

The statement of net assets generally should report all capital assets, including infrastructure assets, and the statement of activities generally should report depreciation expense on those capital assets. However, depreciation is not required for infrastructure assets that are part of a network or subsystem of a network as long as the government manages those assets using an asset management system that has certain characteristics and the government can document that the assets are being preserved approximately at (or above) a condition level established and disclosed by the government as part of RSI (see information later in this section). That alternative treatment for infrastructure assets is termed *the modified approach*. (See also the section this Audit Risk Alert entitled “Revision of State and Local Governmental Units Audit and Accounting Guide” for a discussion of audit issues relating to the modified approach.)

The statement of net assets should report a government’s net assets in three categories—invested in capital assets net of related debt, restricted, and unrestricted. Net assets should be reported as restricted when constraints placed on their use are either externally imposed (for example, by creditors or grantors) or imposed by law through constitutional provisions or enabling legislation. Permanent endowments or permanent fund principal amounts included in restricted net assets should be displayed in two additional components—expendable and nonexpendable.

The government-wide statement of activities should be presented in a format that reports, for each of the government’s functions, expenses reduced by program revenues, resulting in a measurement of “net (expense) revenue.” Program expenses for each function should include at least all of the function’s direct expenses and may include some or all of its indirect expenses. If indirect expenses are allocated, direct and indirect expenses should be presented in separate columns. Program revenues derive directly from the program itself or from parties outside the reporting government’s taxpayers or citizens as a whole. General revenues (such as taxes), contributions to permanent and term endowments, contributions to permanent

fund principal, special items, and extraordinary items should be reported separately after the total net (expense) revenue of the government's functions, ultimately arriving at the change in net assets for the period. Special items are significant transactions or other events that are either unusual in nature or infrequent in occurrence and that are within the control of management. Extraordinary items are transactions or other events that are both unusual and infrequent.

Fund Financial Statements. Fund financial statements should consist of a series of statements that focus on information about the government's major governmental and enterprise funds, including its blended component units. Fund financial statements also should report information about a government's fiduciary funds and component units that are fiduciary in nature. Separate fund financial statements are required for each of the three categories of funds—governmental, proprietary, and fiduciary.

GASB Statement No. 34 refines the definitions of enterprise, internal service, and certain fiduciary funds. It eliminates the expendable and nonexpendable trust funds and creates two new fund types—permanent funds and private-purpose trust funds. Permanent funds, which are governmental funds, report resources that are legally restricted in that only earnings, and not principal, may be used to support the government's programs for the benefit of the government or its citizens. Private-purpose trust funds, which are fiduciary funds, report all trust arrangements (other than pension and other employee benefit trust funds and investment trust funds) for which principal and income benefit individuals, private organizations, or other governments.

Governmental funds should present a balance sheet and a statement of revenues, expenditures, and changes in fund balances using the current financial resources measurement focus and the modified accrual basis of accounting. Governmental fund financial statements should include summary reconciliations to the government-wide financial statements at the bottom of the statements or in accompanying schedules. Proprietary funds should present a statement of net assets and a statement of revenues, expenses, and changes in fund net assets using the economic resources measurement focus and the accrual basis of accounting. In some circumstances, reconciliations

to the government-wide statements may be required. Proprietary funds also should present a statement of cash flows.

The focus of fund financial statements is on *major* governmental and enterprise funds. Major funds should be reported in separate columns in the governmental and proprietary fund financial statements and are determined by a two-step test based on relative percentages of total assets, liabilities, revenues, or expenses and expenditures. The reporting government also may report any other governmental or enterprise fund as a major fund. Nonmajor funds should be reported in the aggregate in a separate column. Internal service funds are excluded from the major fund reporting requirements and should be reported in the aggregate in a separate column on the proprietary fund statements.

Fund balances for governmental funds should be segregated into reserved and unreserved categories. Proprietary fund net assets should be reported in the same categories required for the government-wide financial statements. Proprietary fund statements of net assets should distinguish between current and noncurrent assets and liabilities and should display restricted assets.

Governmental fund statements of revenues, expenditures, and changes in fund balances should separately report revenues, expenditures, other financing sources and uses (including transfers), special items, and extraordinary items.

Proprietary fund statements of revenues, expenses, and changes in fund net assets should distinguish between operating and nonoperating revenues and expenses. Those statements also should report capital contributions, contributions to permanent and term endowments, special items, extraordinary items, and transfers separately at the bottom of the statement to arrive at the all-inclusive change in fund net assets. Cash flows statements should be prepared using the direct method.

Fiduciary fund statements, which should include component units that are fiduciary in nature, should present a statement of fiduciary net assets and a statement of changes in fiduciary net assets using the economic resources measurement focus and the accrual basis of

accounting. Both statements should present separate columns for each fiduciary fund type.

Interfund activity includes interfund loans, interfund services provided and used, and interfund transfers. Interfund activity and the related balances should be reported in the fund financial statements but, in some cases, will be eliminated in the government-wide financial statements.

Notes to the Financial Statements. Previous disclosure standards are continued under GASB Statement No. 34, and certain additional disclosures that are directly related to the provisions of Statement No. 34 also are required. For example, GASB Statement No. 34 requires certain disclosures about significant accounting policies that pertain to the government-wide financial statements, capital assets and long-term liabilities, and enterprise fund segments. (See also the discussion below of the GASB exposure draft outstanding on note disclosures.)

Other Required Supplementary Information. In addition to MD&A, GASB Statement No. 34 requires budgetary comparison schedules to be presented as RSI along with other types of RSI required by previous GASB pronouncements. It also establishes RSI for governments that use the modified approach for reporting infrastructure assets.

RSI should include budgetary comparison schedules for the general fund and for each major special revenue fund that has a legally adopted annual budget. The budgetary comparison schedules should present both (1) the original and (2) the final appropriated budgets for the reporting period as well as (3) actual inflows, outflows, and balances, stated on the government's budgetary basis. Certain disclosures about the budgetary information should be presented in notes to RSI. Alternatively, a government could present its budgetary comparison information in a basic financial statement.

If a government uses the modified approach for its infrastructure assets, RSI and notes thereto should present information about the condition of those assets and about the estimated and actual costs to maintain and preserve those assets approximately at (or above) the government's "target" condition level for those assets.

Help Desk—The AICPA has published (and will be updating in the fall of 2001) a helpful Practice Aid, *Understanding and Implementing GASB's New Financial Reporting Model: A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements* (Product No. 022515kk), to help you and the governments you audit begin the process of understanding the new standards. See the further discussion in “GASB Statement No. 34 Implementation Guidance” later in this section.

GASB Statement No. 35. GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, was issued in November 1999 and extends the scope of GASB Statement No. 34 to include public colleges and universities.

GASB Statement No. 35, through the provisions of GASB Statement No. 34, permits legally separate public colleges and universities to use the guidance for special-purpose governments engaged only in business-type activities, engaged only in governmental activities, or engaged in both governmental and business-type activities in their general purpose external financial statements. Under that guidance, a public college or university is required to include MD&A; basic financial statements, as appropriate for the category of special-purpose government reporting selected, including notes to the financial statements; and RSI other than MD&A.

Public colleges and universities should implement GASB Statement No. 35 depending on the three implementation phases discussed earlier for GASB Statement No 34, based on their revenues (excluding additions to investment in plant or other financing sources and extraordinary items). However, colleges and universities that are a component unit of a state or local government should implement the financial reporting model at the same time as their primary governments, even if that is earlier than its “assigned” phase based on the component unit's revenues. Public colleges and universities that report as special-purpose governments engaged only in business-type activities should retroactively report infrastructure assets at the same time they implement GASB Statement No. 35.

When a public college or university reports as engaged only in business-type activities, GASB Statement No. 34, paragraph 100, requires that its statement of revenues, expenses, and changes in fund net assets distinguish between operating and nonoperating revenues and expenses. Many public colleges and universities receive subsidies and appropriations from state and local governments, and some of those entities may want to classify those amounts as operating revenues because of their significance to their operations. You should be aware that GASB Statement No. 34, paragraph 102, refers to GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, for guidance in defining a proprietary fund's operating revenues and expenses and GASB Statement No. 9, paragraphs 21b and 24b, indicates when grants and subsidies should be reported as noncapital or capital and related financing activities, rather than as operating activity cash flows. Also, according to item 215 of the GASB 34 Q&A, annual operating grants and subsidies should be reported as nonoperating revenues, as illustrated in the nonauthoritative, illustrative financial statements in GASB Statement No. 35. Further, appropriations for capital-related purposes should be reported separately after nonoperating revenues and expenses.

GASB Interpretation No. 6. In March 2000, the GASB issued GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*. The effective date of the Interpretation coincides with the effective date of GASB Statement No. 34 for the reporting government (see the discussion earlier in this section). Earlier application is encouraged provided that the Interpretation and GASB Statement No. 34 are implemented simultaneously.

GASB Interpretation No. 6 addresses certain long-standing concerns about the interpretation and application of modified accrual standards in governmental fund financial statements. GASB Interpretation No. 6 provides a common, internally consistent interpretation of standards for distinguishing the portions of liabilities that should be reported as (1) governmental fund liabilities and expenditures and (2) general long-term liabilities of the government in

certain areas in which practice differences have occurred or could occur. Key points of clarification include the following.

- Unless there is an applicable accrual modification, governmental fund liabilities and expenditures should be accrued. Liabilities that governments normally pay in a timely manner and in full from expendable available financial resources (for example, salaries and utilities) should be recognized when incurred, without regard to the extent to which resources are currently available to liquidate the liability.
- A government's unmatured long-term indebtedness (other than "specific fund debt" of proprietary and trust funds) should be reported as general long-term liabilities, rather than governmental fund liabilities. This applies not only to formal debt issues, such as bonds, but also to other forms of general long-term indebtedness, including compensated absences, claims and judgments, special termination benefits, landfill closure and postclosure care costs, and "other obligations" that are not due for payment in the current period.
- A government may accrue an additional governmental fund liability and expenditure for debt service on general long-term debt, beyond the amounts matured, if it has provided financial resources to a debt service fund for payment of liabilities that will mature early in the following year. A government has provided financial resources if it has deposited or transferred to a debt service fund financial resources that are dedicated for payment of debt service. *Early in the following year* refers to a short time period—usually one to several days and not more than one month.
- Liabilities for compensated absences, claims and judgments, special termination benefits, and landfill closure and postclosure care costs are "normally expected to be liquidated with expendable available financial resources," and should be recognized as governmental fund liabilities, to the extent that they mature each period. The accumulation of financial resources in a governmental fund for eventual payment of unmatured liabilities (for example, compensated absences

expected to become due in future periods) does not constitute an outflow of current financial resources or result in the recognition of an additional governmental fund liability or expenditure. Governments that would prefer accrual-basis reporting for those liabilities in the fund financial statements could consider reporting the activity through a trust fund or an internal service fund.

GASB Exposure Drafts Outstanding

What exposure drafts of proposed pronouncements does the GASB have outstanding?

Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments: Omnibus. In December 2000, the GASB released the exposure draft of a proposed Statement to clarify or modify certain provisions of GASB Statement No. 34. Among the provisions clarified by the exposure draft are the following:

- Requirements for the contents of MD&A
- The financial reporting effect of changing to the modified approach for reporting infrastructure
- Classification of program revenues, including fines and forfeitures
- Major fund criteria

In addition, modifications to the requirements of GASB Statement 34 include eliminating the requirement to capitalize construction period interest for governmental activities and changing the minimum level of detail required for business-type activities in the statement of activities from “segments” to “different identifiable activities.” The exposure draft also includes proposed amendments to GASB Statement No. 21, *Accounting for Escheat Property*, that are necessary because of the changes to the fiduciary fund structure required by GASB Statement No. 34.

The exposure draft proposes that the provisions of the Statement be simultaneously implemented with GASB Statement No. 34. For governments that implemented GASB Statement No. 34 before the

issuance of the Omnibus Statement, its requirements would be effective for financial statements for periods beginning after June 15, 2000. The GASB plans to issue the Omnibus Statement in the summer of 2001 as GASB Statement No. 37.

Certain Financial Statement Note Disclosures. In June 2000, the GASB released the exposure draft of a proposed Statement to establish, modify, and rescind current requirements to disclose certain information in the notes to the financial statements. The exposure draft would rescind the current requirement to report the method a government uses for encumbrances, and also would eliminate the recommendation to report certain budgetary information. The exposure draft proposes changes and additions to note disclosures regarding the following:

- Descriptions of the activities accounted for in financial statement columns
- The length of time (“availability” period) for recognizing governmental fund revenues
- Actions taken to address significant violations of finance-related legal or contractual provisions
- Debt and lease obligations, including variable-rate debt
- Short-term debt activity
- Interfund balances and transfers
- Details about significant individual accounts that are aggregated within larger balances in the financial statements

The exposure draft proposes that the provisions of the Statement be effective at the same time as GASB Statement No. 34 (see the discussion earlier in this section), except that there would be a one-year delay for phase 1 governments for the disclosures concerning short-term debt, disaggregation of balances, and interfund transfers and balances. Early implementation would be encouraged. The GASB plans to issue the Statement in the summer of 2001 as GASB Statement No. 38.

The Financial Reporting Entity: Affiliated Organizations. Released in December 1994, this exposure draft of a proposed Statement would establish standards to determine whether an organization should be classified as an affiliated organization and, if so, would establish criteria to determine whether that affiliated organization is a component unit of a primary government's financial reporting entity. The GASB is reconsidering alternatives for including resources raised, held, or invested by potential component units and may issue a revised ED in the summer of 2001.

Additional GASB Projects

What projects is the GASB working on now?

Although the GASB is continuing to devote significant efforts to the implementation of the new financial reporting model, it has numerous other short- and long-term projects on its agenda. Projects that may see EDs of proposed accounting and financial reporting standards released in 2001 and 2002 include disclosures about deposit and investment risks, other postemployment benefits, environmental liabilities, and the preservation method for infrastructure assets and capital asset impairment. The GASB's conceptual framework project also may result in proposed Concepts Statements in 2001 and 2002.

The GASB also has identified several financial reporting issues as potential long-term projects—(1) fiduciary responsibilities; (2) financial instruments; (3) the financial section of the CAFR; and (4) economic condition, popular, service efforts and accomplishments (performance measurement), and electronic financial reporting.

The GASB staff is working on a second implementation guide for GASB Statement No. 34. (See the section entitled "GASB Statement No. 34 Implementation Guidance" for a discussion of the first implementation guide.) The GASB staff plans to issue the second guide late in 2001. The GASB staff also has issued several "user guides" to GASB Statement No. 34; see the section entitled "GASB Statement No. 34 User Guides."

In January 2001, the GASB added a project to its agenda to consider whether each required column in the financial statements prepared in conformity with GASB Statement No. 34 should be considered a separate basic financial statement. That determination would, in effect, establish the level of materiality for purposes of preparing governmental financial statements and, thus, help to resolve the issue of materiality for purposes of planning and reporting on audits of those financial statements. However, that project is currently inactive as the GASB and AICPA attempt to arrive at a resolution to the matter in other ways. (See also the materiality discussion earlier in this Audit Risk Alert in the section entitled “Revision of State and Local Governmental Units Audit and Accounting Guide.”)

Help Desk—If you are interested in tracking the progress of the GASB’s projects, information is posted and periodically updated on the GASB Web site at www.gasb.org.

Performance Measurements

Is there any new information on performance measurements in government?

If you are interested in the use and reporting of performance measures for governmental services, check out the GASB’s Web site for performance measurement for government at www.seagov.org. That Web site has a wealth of resources on the topic, such as the following:

- Discussions of the nature and purpose of performance measures in governments and GASB’s research on the topic
- Case studies
- Synopses of published articles and news stories
- Links to performance measurement and management-related resources on the Internet
- Contact information for persons involved in performance measurements for governments
- Online discussion groups on developing, reporting, and using performance measures

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- A calendar of pertinent conferences, training seminars, and other events
 - A bibliography
 - A section devoted to citizens, presented in nontechnical language

If a government you audit develops and reports performance measurements, you may be able to use that information when you perform analytical procedures on financial statement amounts as required by SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), for an audit's planning and overall review stages. That is, the relationship of performance measures to financial statement amounts can provide you clues about areas of audit risk and potential financial statement misstatements.

Superseded Audit Guides Still Required for Accounting and Financial Reporting Under GASB Standards

Are certain governmental entities still subject to the accounting and financial reporting guidance in the AICPA's three superseded Audit and Accounting Guides that covered not-for-profit organizations?

The AICPA Audit and Accounting Guide *Not-for-Profit Organizations* superseded three other AICPA Guides: *Audits of Voluntary Health and Welfare Organizations*, *Audits of Colleges and Universities*, and *Audits of Certain Nonprofit Organizations*. However, some of the accounting and financial reporting guidance in those three guides continues to apply to certain governmental entities because GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, and No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, refer to them. If you audit any governments that use the accounting and financial reporting guidance in those guides, you need to be careful about how you use that guidance by considering guidance issued since they were last updated in 1994. Each of the three guides describes at what point the updating process stopped.

You also should know that the accounting guidance in those guides is superseded by GASB Statement No. 34 and No. 35. Once the phased-in implementation of those GASB Statements is complete, the accounting and financial reporting guidance in those guides will no longer apply to any governmental entities. Consequently, the AICPA is no longer selling copies of those three guides.

GASB Statement No. 34 Implementation Guidance

Where can preparers and auditors of governmental financial statements find guidance on implementing GASB Statement No. 34?

Last year, the GASB staff issued a question and answer book, *Guide to Implementation of GASB Statement 34 on Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, to provide direct-from-the-source guidance about applying the provisions of GASB Statement No. 34. That Guide includes the complete standards section from the statement; nearly 300 questions and answers about implementation issues; and illustrative financial statements for a municipal government, an independent school district, and a state government. That Guide also presents alternative approaches and optional reporting and disclosure techniques in a separate appendix. Further, it includes a section that contains ten “how to” exercises, which provide practical explanations and guidance in applying certain complex or innovative provisions of GASB Statement No. 34, such as indirectly determining direct method cash flows and determining major funds. (As discussed in the section entitled “Additional GASB Projects,” the GASB staff is planning a second implementation guide on GASB Statement No. 34.)

A booklet that would fit handily in your briefcase or computer bag is the AICPA’s *Understanding and Implementing GASB’s New Financial Reporting Model: A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements* (Product No. 022515kk). That booklet, which was issued shortly after the GASB issued Statement No. 34, will help you and the governments you audit begin the process of understanding the new standards. The AICPA practice aid booklet includes more than sixty questions and answers that digest the contents of the State-

ment. That publication also refers you to relevant paragraphs in the Statement, analyzes the standards, and identifies issues auditors and preparers should consider early in the implementation planning process. That booklet is a useful reference tool that can be easily distributed to staff and to the governments you audit, and could serve as a basis for training on the new standards. (Remember to be on the lookout this fall for a revision to the practice aid booklet.) In addition, the AICPA has several group- and self-study courses on GASB Statement No. 34. (See the section of this Audit Risk Alert entitled “References for Additional Guidance.”)

Many other organizations, including the Association of School Business Officials International (ASBO), the Government Finance Officers Association (GFOA), the National Association of College and University Business Officers (NACUBO), and the National Association of State Auditors, Comptrollers, and Treasurers (NAS-ACT), also are providing either or both written materials and training programs to help you understand GASB Statement No. 34 and to find answers to implementation questions.

A visit to the GASB Web site might be helpful. That Web site has an area devoted to GASB Statement No. 34 implementation. That area includes a basic overview of and background information about GASB Statement No. 34, a calendar of upcoming training sessions, a bibliography of implementation-related articles, links to Internet sites with information about implementation, and a list of question and answer databases and discussion forums. The site also lists governments that already have implemented the Statement, with links to electronic versions of many of their financial statements.

GASB Statement No. 34 User Guides

How can you help a government assist the users of its financial statements in understanding the changes that will result from GASB Statement No. 34?

The GASB staff recently issued six guides to help financial statement users understand the financial statements that will be prepared using the provisions of GASB Statement No. 34. Those guides are not authoritative pronouncements under the hierarchy of GAAP for governmental entities as provided in SAS No. 69, *The Meaning of*

Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 411).

Two guides, *What You Should Know about Your Local Government's Finances: A Guide to Financial Statements* and *What You Should Know About Your School District's Finances: A Guide to Financial Statements*, were issued in late 2000 and are intended to provide insights to financial statement users—from public finance novices to long-time public sector managers—about how to use financial statement information to make informed decisions. Those guides also are a resource for auditors and government finance officers who need to explain financial statements to elected officials, citizens, and clients. A third guide, *An Analyst's Guide to Government Financial Statements*, was issued in 2001 to help regular and intensive users of governmental financial statements—such as rating agencies, institutional investors, and bond insurers—more effectively assimilate the information from financial statements prepared in conformity with GASB Statement No. 34.

The final three guides are “quick guides”—entitled *The Quick Guide to State Government Financial Statements*, *The Quick Guide to Local Government Financial Statements*, and *The Quick Guide to School District Financial Statements*. Those guides are abbreviated versions of the in-depth user guides and were prepared for legislators, board members, and others who seek a concise, easy-to-read overview of the new governmental financial reporting model.

Technical Inquiries

Where can you get answers to your technical questions about GAAP for state and local governments?

During 2000, the GASB instituted a new system to respond to technical inquiries, a service it traditionally has provided. As resources allow, the GASB staff responds to technical inquiries about governmental accounting and financial reporting to promote the uniform application of GAAP and to foster relations with the GASB's constituency. You should be aware that those responses reflect the staff's opinions in light of the particular circumstances the

inquirer describes and should not be viewed as an official position of the board.

If you have an inquiry that involves general information (such as the status of a current GASB project or the effective date of a statement), you can call or send an e-mail to the assigned staff member. Staff assignments are listed on the GASB Web site. Inquiries that involve an interpretation of accounting standards should be submitted through the GASB technical inquiry system by using a form on the GASB Web site that can be completed and submitted online. Alternatively, you may mail or fax your inquiry on a data input form that is available from the GASB's fax-on-demand department at (203) 847-0700, ext. 14. GASB staff generally respond to your inquiry by telephone within one or two weeks, but the response may take longer depending on staff availability.

Information submitted through the GASB Technical Inquiry System is confidential and will not be shared with any person or organization outside of the GASB and the Financial Accounting Foundation. However, the GASB may use questions submitted anonymously in its staff implementation guides and other GASB publications.

The AICPA's Technical Hotline continues to address members' questions about GAAP for state and local governments submitted by phone. The Technical Hotline now also accepts questions online at the AICPA Web site. Information about this service appears later in the section of this Audit Risk Alert entitled "References for Additional Guidance."

Applicability of FASB Statement No. 133, No. 137, and No. 138

Are governmental entities required to implement the recent FASB Statements on derivatives and hedging activities?

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, was issued in June 1998. That Statement was amended by FASB Statements No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*—an amendment of FASB Statement No. 133, issued June 1999, and No. 138, *Accounting for Cer-*

tain Derivative Instruments and Certain Hedging Activities—an amendment of FASB Statement No. 133, issued June 2000. FASB Statement No. 133, as amended, became effective for all fiscal quarters of all fiscal years beginning after June 15, 2000.

FASB Statement No. 133, as amended, establishes accounting and financial reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (1) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (2) a hedge of the exposure to variable cash flows of a forecasted transaction, or (3) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. FASB Statement No. 133, as amended, amends or supersedes various FASB pronouncements relating to the accounting and financial reporting (including note disclosures) relating to derivatives and hedging.

GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, paragraph 7, as amended by GASB Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, permits a proprietary activity to elect to apply all FASB Statements and Interpretations issued after November 30, 1989, that are developed for business enterprises, except for those that conflict with or contradict GASB pronouncements. Therefore, proprietary activities that have made a “paragraph 7 election” to apply post-November 30, 1989, FASB pronouncements should consider whether and how to apply the provisions of FASB Statement No. 133, as amended, which has certain provisions that do not conflict with or contradict GASB pronouncements. The GASB Web site advises those who have gen-

eral questions about the applicability of FASB Statement No. 133, as amended, to contact project managers Randy Finden at (203) 847-0700, ext. 240, or rjfinden@gasb.org; or Wesley Galloway at (203) 847-0700, ext. 272, or wagalloway@gasb.org. If you have a specific question about FASB Statement No. 133, as amended, that involves an interpretation of the accounting standards, you should use the GASB's technical inquiry system as discussed earlier in this section of this Audit Risk Alert at "Technical Inquiries."

Executive Summary—Accounting Issues and Developments

- GASB Statement No. 33 and No. 36 and GASB Interpretation No. 5 generally become effective during 2001. GASB Statement No. 34 and No. 35 and GASB Interpretation No. 6 do not become effective until after 2001, although early application is encouraged.
 - The GASB has three exposure drafts of proposed pronouncements outstanding.
 - Some of the accounting and financial reporting guidance in three superseded AICPA guides continues to apply to certain governmental entities until superseded by GASB Statement No. 34 and No. 35.
 - Various guidance information on implementing GASB Statement No. 34 includes a question-and-answer book from the GASB staff, a practice aid booklet and group- and self-study courses from the AICPA, written materials and training programs from many other organizations, and a GASB Web site area devoted to GASB Statement No. 34 implementation.
 - The GASB staff recently issued six guides to help financial statement users understand the financial statements that will be prepared using the provisions of GASB Statement No. 34.
 - The GASB has instituted a new system to respond to technical inquiries. The AICPA's Technical Hotline also addresses members' questions about GAAP for state and local governments submitted by phone or online at the AICPA Web site.
 - Proprietary activities that have made a "paragraph 7 election" under GASB Statement No. 20 to apply post-November 30, 1989, FASB pronouncements should consider whether and how to apply the provisions of FASB Statement No. 133, as amended.
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References for Additional Guidance

AICPA

Publications

The following AICPA publications may be of interest to auditors of state and local governments.

- Audit and Accounting Guide *Audits of State and Local Governmental Units* (Product No. 012062kk)
- SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (Product No. 014887kk)—Note that this SOP is available as an appendix to the Audit and Accounting Guides for state and local governmental units (see previous bullet for product number) and not-for-profit organizations (Product No. 013394kk). It also is included in *AICPA Technical Practice Aids* (Product No. 005140kk).
- SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*—Note that this SOP is available as an appendix to the Audit and Accounting Guides for state and local governmental units and not-for-profit organizations and in *Technical Practice Aids* (see bullets above for product numbers).
- *Understanding and Implementing GASB's New Financial Reporting Model* (Product No. 022515kk)—This publication provides a summary of the significant portions of GASB Statement No. 34, answering the most important questions about the new requirements for the annual financial reports of state and local governments. Additionally, assessments of the new standard are provided, as well as insights into planning and implementation issues. For a more detailed description of this publication, see the section of this Audit Risk Alert entitled “GASB Statement No. 34 Implementation Guidance.”
- *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133*, Audits of States, Local Governments, and Non-Profit Organizations (Product No.

006607kk)—This Practice Aid contains comprehensive analyses and guidance on applying OMB Circular A-133. The publication includes numerous audit checklists and illustrative examples to help auditors perform audits that comply with regulations. For a more detailed description of this publication, see the section of this Audit Risk Alert entitled “AICPA Single Audit Guidance.”

- *Checklists and Illustrative Financial Statements for State and Local Governmental Units* (Product No. 008774kk)—Updated annually, this publication provides checklists and illustrations of financial statements and note disclosures and auditors’ reports, including reports in accordance with *Government Auditing Standards* and the Single Audit Act Amendments of 1996.
- *Audit and Accounting Manual* (Product No. 007260kk)—Updated annually, this publication has an extensive section of internal control questionnaires and audit programs for audits of governmental entities, including audits in accordance with the Single Audit Act Amendments of 1996.
- *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883kk)—This Practice Aid walks auditors through issues likely to be encountered in applying SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU secs. 110, 230, 312, and 316), to audits, including valuable tools such as sample documentation. The publication also provides specific guidance on applying the concepts of the SAS to various industries, including government.

Continuing Professional Education Courses

The AICPA offers continuing professional education (CPE) in the form of both group-study and self-study courses, and in print and video format.

Group study courses include the following:

- A-133: Merging Compliance Supplement, Cost Circulars and Audit Guides

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- Advanced Auditing of HUD-Assisted Projects
 - Applying A-133 to Nonprofit and Governmental Organizations
 - Applying Fraud SAS No. 82 in Governmental and Not-for-Profit Audits
 - Auditing State and Local Governments
 - Audits of HUD–Assisted Projects
 - Audits of Public Schools
 - GASB No. 34 Implementation: From Here to There
 - GASB No. 34 Infrastructure: How in the GASB Are We Going to Do This?
 - Government Reporting Models for 2000 and Beyond (GASB 34)
 - Governmental Accounting and Auditing Update
 - Governmental and Nonprofit Annual Update
 - Performance Audits of Governmental Entities
 - Solving Complex Single Audit Issues for Government and Nonprofit Organizations
 - Workpaper Preparation Techniques for Government and Nonprofit Organizations
 - Yellow Book: *Government Auditing Standards*

Self-study courses include the following (all product numbers appear in parentheses after the course titles):

- Advanced Auditing of HUD-Assisted Projects (730185kk)
- Applying A-133 to Nonprofit and Governmental Organizations (730195kk)
- Applying Fraud SAS No. 82 in Governmental and Not-for-Profit Audits (735135kk)

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- Auditing State and Local Governments (730285kk)
 - Audits of HUD-Assisted Projects (730290kk)
 - Audits of Public Schools (739080kk)
 - GASB No. 34 Implementation: From Here to There (731565kk)
 - GASB No. 34 Infrastructure: How in the GASB Are We Going to Do This? (731560kk)
 - Government Reporting Models for 2000 and Beyond (GASB 34) (735170kk)
 - Governmental Accounting and Auditing Update (736466kk)
 - Introduction to Governmental Accounting (735201kk)
 - Performance Audits of Governmental Entities (737055kk)
 - Solving Complex Single Audit Issues for Government and Nonprofit Organizations (734403kk)
 - Workpaper Preparation Techniques for Government and Nonprofit Organizations (732628kk)
 - Yellow Book: *Government Auditing Standards* (736108kk)

The following video courses also are available:

- Government Reporting Model for 2000 and Beyond (GASB 34) (180175kk)
- Governmental Accounting and Auditing Update (186462kk)
- Implementing the New Government Reporting Model (350005kk)
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations (184401kk)
- Federal Accounting, Reporting, and Auditing Update (181008kk)
- Workpaper Preparation Techniques for Government and Nonprofit Organizations (182628kk)

Online CPE Offer!

The AICPA now offers an online learning library, AICPA InfoBytes. An annual fee (\$95 for members and \$295 for nonmembers) offers unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

To order AICPA products, call (888) 777-7077 (menu selection #1); write the AICPA Order Department, P.O. Box 2209, Jersey City, NJ 07303-2209; or fax (800) 362-5066. The best times to call are 8:30 a.m. to 11:30 a.m. and 2:00 p.m. to 7:30 p.m., Eastern Standard Time. Also, visit the AICPA's Web site (www.aicpa.org) to obtain product information and place online orders.

Industry Conferences

The AICPA will hold its eighteenth annual National Governmental Accounting and Auditing Update Conference on August 20-21, 2001, in Washington, D.C., and again on September 24-25, 2001, in Denver, Colorado. This high-level conference is designed for practitioners; officials working in federal, state, or local governmental finance and accounting; and recipients of federal awards. It is the premier forum for the discussion of important governmental accounting and auditing developments. Participants will receive updates on current issues, practical advice, and timely guidance on recent developments from experts.

The AICPA also offers an annual training program called the National Governmental and Not-for-Profit Training Program. This year's program will be held on October 22-24, 2001, in Orlando, Florida. It is designed for practitioners or accountants, auditors, and other staff in government who want in-depth, hands-on training in government accounting and auditing. For more information about the conference or the training program, please call the AICPA CPE Conference Hotline at (888) 777-7077.

Accounting and Auditing Technical Hotline

The Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077 or visit the AICPA Web site at www.aicpa.org.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

AICPA Home Page

The AICPA has established a home page on the World Wide Web. AICPA Online, the AICPA's Web site at www.aicpa.org, offers members a unique opportunity to stay abreast of developments in accounting and auditing. CPAs can benefit tremendously by using online resources such as professional news, membership information, state and federal legislative updates, AICPA press releases, speeches, and exposure drafts, among other things. The home page also features a "Talk to Us" section for members who want to send e-mail messages directly to AICPA representatives or teams. Also, with a comprehensive list of links to other accounting- and finance-related sites, AICPA Online serves as a gateway to additional Internet resources. The home page also includes a separate section that deals with single audit issues. Look for this information at www.aicpa.org/belt/a133main.htm. Also, CPAs that work in government should note that there is a separate section of the AICPA home page devoted specifically to them. Look for this information at www.aicpa.org/members/div/cpagov/index.htm.

Fax Hotline

The AICPA has a Fax Hotline that enables members to obtain pertinent information from a fax machine twenty-four hours a day, seven days a week. Current AICPA comment letters, conference brochures and registration forms, CPE information, AcSEC actions, and legislative news are among the documents that can be retrieved on the Fax Hotline. To access the hotline, dial (201) 938-3787 from a fax machine, follow the voice cues, and when prompted, provide the number(s) of the document(s) desired. A list of all items available through this service may be obtained via the Fax Hotline by entering document number 1.

Governmental Accounting Standards Board

GASB publications can be obtained by calling the GASB Publication Department at (800) 748-0659. Publications are also available from the GASB Order Department (P.O. Box 30784, Hartford, CT 06150, payment by check); phone (800) 748-0659); or on its Web site at www.gasb.org.

The GASB offers the following publications and services.

- *Codification of Governmental Accounting and Financial Reporting Standards*. The 2000–2001 edition is as of June 30, 2000. An updated edition as of June 30 each year is issued in late summer. Beginning with the June 30, 2001 edition, the GASB will issue two versions of the *Codification*—one incorporating GASB Statement No. 34 and related pronouncements for governments that will begin to implement the standards in 2001 and the other with those standards remaining in an appendix.
- *GASB Original Pronouncements*, as of June 30, 2000. An updated edition as of June 30 each year is issued in late summer. As with the *Codification*, the GASB will issue two versions of *Original Pronouncements* beginning with the June 30, 2001 update—one that indicates the effects of GASB Statement No. 34 and related pronouncements and the other without.
- *GASB implementation guides*. Implementation guides are authored by GASB staff to explain how to implement a particular GASB Standard. They are written in question-and-answer format, organized based on the general topics in the standard. Guides have been issued for Statement No. 3, No. 9, No. 10, No. 14, Nos. 25-27, No. 31, and No. 34. Guides are not part of the GASB's subscription service.
- *GASB user guides*. The GASB has published a series of guides to assist different users of government financial statements in understanding what information can be found in financial statements prepared under GASB Statement No. 34. The guides that have been issued are: *What You Should Know*

About Your Local Government's Finances: A Guide to Financial Statements, What You Should Know About Your School District's Finances: A Guide to Financial Statements, and An Analyst's Guide to Government Financial Statements. In addition, the series includes three “quick guides”—abbreviated versions of the more complete guides—*The Quick Guide to Local Government Financial Statements, The Quick Guide to School District Financial Statements, and The Quick Guide to State Government Financial Statements.*

- *GASB Web site*—Information about the GASB can be found on its Web site, www.gasb.org. The site features a section on GASB Statement No. 34 with a calendar of training sessions and seminars and links to online resources about the Statement. The “What’s New?” section contains the latest news about the GASB and governmental accounting, as well as calendars of GASB meetings, speaking engagements, constituent events, outstanding due process documents, the current-period technical plan, and other frequently requested materials. Other items include “Facts about GASB”; summaries of all final GASB documents and ordering information; and a list of board members, staff, and advisory council members with their e-mail addresses.
- *Performance Measurements for Governments Web site*—The GASB’s other Web site, located at www.seagov.org, is a clearinghouse for information about the development, use, and reporting of performance measures for governments. The site’s main features include a citizens’ guide and links to government performance indicators, studies, reports, government sites, ongoing projects, and several online discussion groups.
- *Fax Information System*—The GASB has a twenty-four-hour fax system that enables interested persons to obtain information on upcoming meetings, the current-period technical plan, and “Facts about GASB.” To access the system, dial (203) 847-0700, ext. 14, from a fax machine, and follow the voice cues.

Federal Agencies—Administrative Regulations

Most federal agencies issue general administrative regulations that apply to their programs. These regulations provide general rules on how to apply for grants and contracts, how grants are made, the general conditions that apply to and the administrative responsibilities of grantees and contractors, and the compliance procedures used by the various agencies. Those regulations are included in the *Code of Federal Regulations*.

In 1988, a final rule, *Uniform Administrative Requirements for Grants and Cooperative Agreements with State and Local Governments*, was published, establishing a common rule to create consistency and uniformity among federal agencies in the administration of grants to and cooperative agreements with state, local, and federally recognized Indian tribal governments. The common rule has been codified in each federal agency's portion of the *Code of Federal Regulations*.

General Accounting Office

GAO publications and services include the following:

- *Government Auditing Standards, 1994 Revision as Amended*—These standards, also referred to as the Yellow Book, relate to audits—both financial and performance—of governmental organizations, programs, activities, and functions, and of governmental funds received by contractors, nonprofit organizations, and other nongovernmental organizations. The standards incorporate the AICPA SASs for fieldwork and reporting, and prescribe additional standards to meet the more varied interests of governmental audit report users. The 1994 revision and its amendments (see below) are for sale by the Superintendent of Documents, U.S. Government Printing Office (GPO), Washington, DC 20401; phone (202) 512-1800; fax (202) 512-2250; Product No. 020-000-00-265-4. The current codification of the standards that includes Amendment No. 1 and No. 2 (see below) is available on the Yellow Book section of the GAO Web site at www.gao.gov/govaud/ybk01.htm.

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- *Government Auditing Standards: Amendment No. 1, Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems* (GAO/A-GAGAS-1)—In May 1999, the GAO issued its first amendment to the 1994 version of *Government Auditing Standards*. The amendment establishes a new field work standard requiring documentation in the planning of financial statement audits in certain circumstances. An electronic version can be accessed through the Yellow Book section of the GAO Web site (see above).
 - *Government Auditing Standards: Amendment No. 2, Auditor Communication* (GAO/A-GAGAS-2). Issued in July 1999, this second amendment to *Government Auditing Standards* requires specific communication concerning the auditor's work on compliance with laws and regulations and internal control over financial reporting. The amendment also requires the auditor to emphasize in the auditor's report on the financial statements the importance of the reports on compliance with laws and regulations and internal control over financial reporting when these reports are issued separately from the report on the financial statements. An electronic version can be accessed through the Yellow Book section of the GAO Web site (see above).
 - *Interpretation of Continuing Education and Training Requirements—Government Auditing Standards* establishes specific CPE requirements for auditors working on audits performed in accordance with those standards. This interpretation guides audit organizations and individual auditors on implementing the CPE requirements by answering the most frequently asked questions from the audit community. This interpretation was effective for CPE reporting periods beginning on or after January 1, 1991, and is available on the Yellow Book section of the GAO Web site (see above).
 - *GAO on the World Wide Web*—GAO issues hundreds of reports and testimony to the Congress each year on a variety of subjects, including accounting, budgeting, and financial management. Now the full text of GAO products can be retrieved

via the Internet. GAO's Web site is at www.gao.gov. Full text files are available in both PDF and HTML versions. ASCII files are available through a direct link from the Web site. For information on how to access GAO reports or other documents on the Internet, send an e-mail message to info@www.gao.gov. GAO's Web site is updated daily and, besides the items discussed above, includes—

- The GAO Daybook, a daily listing of released reports and testimony.
- The monthly catalog of reports and testimony (with links to most documents listed).
- Reports and testimony released since the last monthly catalog.
- Comptroller General Decisions and legal opinions.
- GAO Policy Documents.
- Special publications, including GAO Annual Index and GAO Annual Report.

Unless otherwise noted, requests for hard copies of these publications should be sent to the GAO, P.O. Box 37050, Washington, DC 20013; phone (202) 512-6000. Orders also may be placed by using the fax number (202) 512-6061.

Office of Management and Budget

Circulars

The OMB issues cost and grants management circulars to establish uniform policies and rules to be observed by federal agencies for the administration of federal grants. Federal agencies then adopt these circulars in their regulations. The process for issuing circulars includes due process, with a notice of any proposed changes in the *Federal Register*, a comment period, and careful consideration of all responses before issuance of final circulars. The following table includes a list of circulars relevant to audits of state and local governments. Copies of these circulars are available under the grants management heading on the OMB Web site at www.whitehouse.gov/OMB.

OMB Circulars Relevant to Audits of State and Local Governments

<i>Circular Number</i>	<i>Title</i>	<i>Issue Date</i>
A-21 (Revised)	Cost Principles for Educational Institutions	August 2000
A-87 (Revised)	Cost Principles for State, Local, and Indian Tribal Governments	August 1997
A-102 (Revised)	Grants and Cooperative Agreements With State and Local Governments	August 1997
A-110 (Revised)	Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations	September 1999
A-133 (Revised)	Audits of States, Local Governments, and Nonprofit Organizations	June 1997

OMB Circular A-133 *Compliance Supplement*

The Supplement (appendix B in OMB Circular A-133) sets forth the major federal compliance requirements to consider in a single audit of states, local governments, and nonprofit organizations that receive federal assistance. You can find the 2001 Supplement (and the preceding 2000 Supplement) on the OMB's Web site at the grants management address, www.whitehouse.gov/OMB/grants. You may purchase a printed copy (Product No. 041-001-00562-5) or CD ROM version (Product No. 041-001-00563-3) of the 2001 Supplement from the Government Printing Office at (202) 512-1800.

Other Guidance

OMB-Prescribed Grants Management Standard Forms. Standard forms prescribed by OMB's grants management circulars can be obtained on the grants management section of OMB's Web site (see above). The data collection form (Form SF-SAC) which is required to be completed for all single audits, can be completed online at the Federal Audit Clearinghouse Web site at harvester.census.gov/sac. That site also has PDF files of the data collection form.

The *Catalog of Federal Domestic Assistance* (CFDA) is a government-wide compendium of federal programs, projects, services, and activities that provide assistance or benefits to the public. Program infor-

mation provided by the CFDA includes authorizing legislation and audit requirements. The General Services Administration (GSA) is responsible for the dissemination of federal domestic assistance information through the catalog and maintains the information database from which program information is obtained. A searchable version of the CFDA is located at www.cfda.gov.

The GSA also makes copies of the CFDA available to certain specified national, state, and local government offices. Catalog staff may be contacted at (202) 708-5126. The catalog may be purchased from the GPO by calling (202) 512-1800.

The CFDA also is available on machine-readable magnetic tape, high-density floppy diskettes, and CD-ROM. These may be purchased by contacting Federal Domestic Assistance Catalog Staff (MVS), General Services Administration, 300 Seventh Street, SW, Suite 101, Washington, DC 20407 or calling (202) 708-5126.

PCIE Audit Committee Guidance

The PCIE Audit Committee publishes supplemental, nonauthoritative guidance for federal officials addressing issues arising from the implementation of the Single Audit Act and related OMB Circulars.

Over the years, the PCIE Audit Committee (or its predecessors) has issued a total of six position statements. Most of these position statements were developed to address issues related to audits conducted under the Single Audit Act of 1984, Circular A-128, and the March 1990 version of Circular A-133. Only PCIE Statement No. 4, which establishes uniform procedures for referrals of substandard audits to state boards of accountancy and the AICPA, continues to be applicable to audits conducted under the Single Audit Act Amendments of 1996 and the June 1997 Circular A-133. You can find PCIE Statement No. 4 on IGnet, the Inspectors General Web site, in the Single Audit Library. The Internet address for that library is www.ignet.gov/pande/audit/mains.html.

Note that the PCIE Audit Committee also is responsible for developing nonfederal audit review guidelines in the form of a desk review guide and a quality control review guide. Those guides, which have been recently updated for the Single Audit Act Amendments

of 1996 and the June 1997 revision to Circular A-133, are available at the Internet address in the paragraph above.

Government Finance Officers Association

Government Finance Officers Association (GFOA) publications include the following:

- *The New Blue Book for the New Model GAAFR: Using the GASB 34 Model*—This publication provides detailed professional guidance on the practical application of the new financial reporting model to state and local governments. (The New *GAAFR Study Guide Outlines and Exercises* also is available to assist those wishing to use the GAAFR for instructional or self-study purposes.)
- *An Elected Official's Guide to the New Governmental Financial Reporting Model*—This publication provides a comprehensive overview of the new governmental financial reporting model established by GASB Statement No. 34. The discussion is reinforced by a number of simple exhibits illustrating the key concepts of the new model.
- *Recommended Practices for State and Local Governments*—The 2000 update is a compilation of recommended practices in public financial management. They are intended to identify enhanced techniques and provide effective strategies for state and local governments. The recommended practices are presented in the areas of accounting, auditing, and financial reporting; cash management; budgeting and financial management; debt management; and retirement and benefits administration.
- *Audit Management Handbook*—This handbook on audit management is intended for state and local governments and CPA firms that are involved in obtaining or performing financial audits. It provides information on all aspects of the audit management process, including establishing the scope of the audit, audit procurement (including a model request for proposal), monitoring the audit, and the resolution of audit findings.

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- *A Guide to Arbitrage Requirements for Governmental Bond Issues and 1994 Supplement*—These two publications present a comprehensive overview of federal arbitrage requirements.
 - *An Elected Official's Guide to Auditing*—This booklet provides elected officials, management and other nonaudit professionals with practical information concerning the audit process for state and local governments. Easy-to-follow explanations cover: annual audits of financial statements; Yellow Book audits; single audits; auditor's reports; managing the financial audit; performance auditing; and internal auditing. Throughout, the booklet follows a simple question-and-answer format that makes it suitable for distribution to those new to the world of public-sector auditing.
 - *Pension Accounting and Reporting; Pension CAFRS: Guidelines for the Preparation of a Public Employee Retirement System Comprehensive Annual Financial Report; 2000 Survey of State and Local Government Employee Retirement Systems—Survey Report; and the PENDAT 2000 Database and User's Manual*—Various publications and other products on the administration of and financial reporting for PERS.

The GFOA can be contacted at 180 N. Michigan Avenue, Suite 800, Chicago, IL 60601-7476; phone (312) 977-9700; fax (312) 977-4806; Internet address: www.gfoa.org.

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This Audit Risk Alert replaces *State and Local Governmental Developments—2000*. The *State and Local Governmental Developments* Audit Risk Alert is published annually. As you encounter audit and industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be greatly appreciated. You may e-mail these comments to lgivarz@aicpa.org or write to:

Leslye Givarz
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

We also suggest that you review the AICPA *Audit Risk Alert—2000/2001*, which is a general update on economic, auditing, accounting, and other professional developments. That publication discusses numerous general audit topics of interest that, although not specifically geared toward an audit of the financial statements of state and local governments, might be relevant to auditors of those financial statements.

The Internet—An Auditor’s Research Tool

If used properly, the Internet can be a valuable tool for auditors. Through the Internet, auditors can access a wide variety of global business information. For example, information is available relating to professional news, state CPA society information, IRS activities, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are such materials accessible from the computer, but also they are available at any time, often free of charge.

A number of resources provide direct information, whereas others may simply point to information inside and outside of the Internet. Auditors can use the Internet to—

- Obtain audit and accounting research information.
- Obtain information, regulations, and documents from federal agencies and departments.
- Discuss audit issues with peers.
- Communicate with audit clients.
- Obtain information from a client’s Web site.
- Obtain information from professional associations.

There are caveats to keep in mind when using the Internet. Reliability varies considerably. Some information on the Internet has not been reviewed or checked for accuracy; we advise caution when you access data from unknown or questionable sources. Although a vast amount of information is available on the Internet, much of it may be of little or no value to auditors. Accordingly, auditors should learn how to use search engines effectively and efficiently. The Internet is best used in tandem with other research tools, because it is unlikely that all desired research can be conducted solely from Internet sources.

The following listing summarizes the various Web sites of many of the organizations referred to in this Audit Risk Alert, as well as others that auditors of state and local governments may find useful.

<i>Organization</i>	<i>Web Site Address</i>
American Institute of CPAs:	
Main page	www.aicpa.org
Single audit page	www.aicpa.org/belt/a133main.htm
Department of Education Office of Inspector General Non-Federal Audit Team	www.ed.gov/offices/OIG
Department of Housing and Urban Development:	
Office of Inspector General	www.hud.gov/oig
Real Estate Assessment Center	www.hud.gov/offices/reac
Federal Audit Clearinghouse	harvester.census.gov/sac
Federal Aviation Administration, Office of Airports, Passenger Facility Charge Branch	www.faa.gov/arp/530home.htm
FinanceNet (the federal Chief Financial Officers Council's site)	www.financenet.gov
Financial Accounting Standards Board	www.fasb.org
General Accounting Office:	
Main page	www.gao.gov
<i>Government Auditing Standards</i> section	www.gao.gov/govaud/ybk01.htm
General Services Administration	www.gsa.gov
Government Finance Officers Association	www.gfoa.org
Governmental Accounting Standards Board:	
Main page	www.gasb.org
Performance Measurement for Government	www.seagov.org
U.S. House of Representatives	www.house.gov
IGnet (the federal Inspectors General site):	
Main page	www.ignet.gov
Single audit library	www.ignet.gov/pande/audit/mains.html
Internal Revenue Service:	
Main page	www.irs.gov
Exempt Organizations segment	www.irs.gov/bus_info/eo
Employee Plans segment	www.irs.gov/bus_info/ep
Federal, state, and local governments	www.irs.gov/bus_info/fslg
Tax-exempt bonds	www.irs.gov/bus_info/bonds
Library of Congress	lcweb.loc.gov

<i>Organization</i>	<i>Web Site Address</i>
Municipal Securities Rulemaking Board	www.msrb.org
National Archives and Records Administration (to search Code of Federal Regulations, Federal Register, and Public Laws)	www.access.gpo.gov/su_docs/index.html
National Association of State Auditors, Comptrollers, and Treasurers	www.sso.org/nasact
Office of Management and Budget:	
Main page	www.whitehouse.gov/OMB
Grants management section	www.whitehouse.gov/OMB/grants
Securities and Exchange Commission	www.sec.gov
U.S. Senate	www.senate.gov
Thomas Legislative Search	thomas.loc.gov
